

1-1-1972

Transcript of proceedings: Public hearing of the Accounting Objectives Study Group, Section I; Trueblood report

American Institute of Certified Public Accountants. Study Group on the Objectives of Financial Statements

Robert M. Trueblood

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SECTION I

TRANSCRIPT OF
PROCEEDINGS

PUBLIC HEARING OF THE
ACCOUNTING OBJECTIVES STUDY GROUP

May 15, 16, and 17, 1972
The Americana Hotel
New York, New York

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MONDAY MORNING SESSION

May 15, 1972

A Public Hearing before the Accounting Objectives Study Group of the American Institute of Certified Public Accountants convened at fifteen minutes past nine o'clock in the Imperial Ballroom "B" at the Americana Hotel, New York City, New York, Mr. Robert M. Trueblood of Touche Ross & Co., past President of the Institute and Chairman of the Study Group, presiding.

CHAIRMAN TRUEBLOOD: We have just a few preliminaries. I think all of you who are here know about the history of the two Study Groups - the Wheat Report, or the Wheat Commission on the structure of the Accounting Principles Board - and you should all be aware that that report has been approved in its entirety by Council of the American Institute and endorsed, I feel quite strongly, by FEI, FAF, AAA, FGAA, NAA and the Chairman of the Securities and Exchange Commission. So, the restructuring Board is under way; the schedule is that the trustees should be established, hopefully, by July 1, with an organization meeting at or about that time, and with appointment of the members of the new Standards Board to be operational, hopefully, by January 1 of next year.

Meanwhile, the Accounting Principles Board continues with its ongoing work. You know that our Group is a rather different kind of organization. Our work is conceptual, philosophical; it will, in effect, become input to the Standards Board. We do not have any present plans about how to handle our ultimate output. Our schedule is for a preliminary report no later than

the fall of this year.

I want, first, to remind those of you who are participating in our work, if only because some of the input to this Group has raised some question about the composition of our Group-- I would remind those who have raised that question that, statistically, no sample, less than thirty, can possibly, mathematically, be representative -- so, no matter how we work the Group, we couldn't pass that test.

We have name cards here at the table, but I would like to tell you that Sid Davidson is, as most of you know, Dean of the Graduate School of Business at the University of Chicago; he is an economist and an accountant.

Dean Don Edwards, Dean of the School of Business at the University of Minnesota.

Reed Parker, Duff, Anderson & Clark, recent past President of the National Financial Analysts group, and with us as a full-time member. Howie Wagner is Executive Vice President, Finance, of the Jewel Companies, Inc., in Chicago. Oscar Gellein, at my immediate right, is a Partner in the firm of Haskins & Sells. I am going to ask Oscar, during the day, or during the next three days, to spell me at the chairing role.

On my left is George Sorter, also of the University of Chicago, essentially full-time Research Director for the Group. Next to him is Dave Herwitz, from the Harvard Law School, who is Counsel for the Group. He meets with us regularly and is doing some independent research on various subjects that we have to deal with.

Frank Weston, Partner in Arthur Young & Company, and member of the basic Group.

Our initial witnesses are to the left and will introduce themselves later.

I would like to tell you that as Dean Cyert of Carnegie Graduate School of Business is unable to be here today--he is a member of the Group--because of a commencement at his institution. I would also like to announce that Dean Cyert has become President of Carnegie-Mellon University very recently, and will take office midsummer.

Also absent this morning, but he will be here this afternoon, is Andy Reinhart, who is a Group Vice President for North American Operations of The Singer Company. He is, I believe, at a stockholders' meeting this morning.

Now, also working on an ongoing basis with our Group are a number of people in various capacities who are here with us today, and I am going to ask these men to rise just for identification as I call their names, because if you need anything or have any questions they are on the floor and will be able to help you. First, Marty Gans, from Chicago--Touche Ross; then, Mike Shannon--Arthur Andersen, Chicago; and Bob Streit, Ernst & Ernst, Chicago; in the back of the room, Paul Rosenfield, from the Institute--has been working with us, full time. I do not see him here yet--I understand, we are having continuing subway trouble. Yuji Ijiri, of Carnegie-Mellon is here; he acts as President Cyert's observer. Gordon Johns--he is here this morning, Oscar? And James Goble, of Peat, Marwick, Chicago, observed the Group's activity on a

full-time basis.

Now as for where we are and where we stand, you all know that we have three days of public hearings scheduled, and the agenda is chock full. It's very tight, and we are going to have to hold to this schedule very tightly, but I think it might be well to indicate to you just where we stand. This is probably the final piece of formal input to the Group. One of our operations, so far, has been to interview in depth, some fifty users of financial reports from a variety of disciplines. Each of these persons has been interviewed by a member of the Study Group and a staff member of the Study Group, and their input has been made available to all of our Group. In that interview process we have also picked up in depth conversations with all of those people who have recently written on the subject of objectives -- people like Sprouse, Moonitz, Paton, Storey, Grady, and so forth.

As a Study Group, we have met informally with some twenty-five major user groups and professional groups. Our only disappointment here is that, generally speaking, we have been unable to make arrangements to work with consumer groups as such -- I think, particularly, of the labor unions, who have shown no interest or desire to work with us on a formal input basis. We haven't given up on that; since Arnie Weber is back from Washington we are hoping to use him to try to get with some labor groups -- but, generally speaking, we have had a lack of success in working with consumer groups, as such. Nonetheless, considering these group meetings and personal interviews, we have talked with as many as two hundred and fifty people; we have some twenty to

thirty presentations scheduled for the next three days -- and, after that, we have only five formal meetings to go through -- one with the Securities Exchange Commission, one with the General Accounting Office, with emphasis on the UCA's side, and three major media in New York have agreed to make available a group of financial writers to meet with us. We have corresponded, sporadically perhaps, but systematically with some five to six thousand individual corporations and professional groups in the United States and overseas, and this has been very helpful.

We have come across papers, research being done by other groups. This has all been very helpful to us, and all the professional groups in this country, of course, are presubmitting to us their presently ongoing research.

Now in tandem with these peripheral investigations, we have been conducting inquiries on a conceptual-theoretical level. I didn't name them for you, but we have four or five people on contract doing particular things such as experimenting with fair value proposals; we have another man analyzing the literature on social responsibility, and all of that work will come together. So whatever accounting objectives might ultimately be, it is our view that these should follow from a logical approach, from a rationale that can be conceptually supported and from an intellectual framework which stands on more than the shaky footing of hearsay or personal opinion.

Now as for today's proceedings, I said previously that we have so many presentations to work into three days that we are going to have to have you adhere very tightly to the time

schedule. Now the procedure will be that the witness will make a very short presentation -- hopefully, ten to fifteen minutes, no more than twenty -- and I will use the gavel harshly, because we want to give each of them an opportunity to be questioned by members of the Study Group. I think I should tell you that members of the Group may well play the devil's advocate as well as ask questions for purposes of clarification. Each of the participants on the "witness stand" without exception has pre-submitted a full paper, which they will probably summarize or expand upon in their presentation.

Day by day, a complete set of papers being talked about during the day will be available at the back of the room.

We are going to start out trying not to use direct questioning from the floor, because of its awkwardness; however, each of you, if you have a question of the witness, should write it out, give it to one of our representatives on the floor, and we will work it into the proceedings as we go along. If that procedure proves to be too awkward, we will try to amend it -- but, because of the time schedule, we think we are going to stick to the requirement for written questions for the time being.

You will note that we have a court reporter with us; everything said by everybody will go into the formal record. A complete, formal transcript will be available shortly at a price. Some of you have already indicated that you want such a complete transcript when it is available.

Any other input which we have received is not being distributed today, but will become a part of the formal, public

record when our work is done. We presently contemplate a three-volume output. Volume One will be the objectives as such, and whether that will take one page or a hundred pages, we don't yet know. Volume Two is going to be the formal exposition of all of the very helpful inputs which have been received from people all over the world. Volume Three will involve a scenario of the project from its inception to completion for archival purposes.

Just two or three other things. The press has been invited; the major media may be here from time to time. They have been supplied with all the papers which are being discussed today, with the admonition that they are not to be used until the presenter has presented it, but there may be some press coverage of these particular proceedings.

I would also tell you that we have a room, 4802, for the Study Group; if we aren't at the table here, that is perhaps where we will be. And the press room is 4301. There are also copies of the papers there, and from time to time some of us here at the table may have to go to one or the other of these rooms to take care of some of our homework and our paperwork, and possibly some of our visitors.

I want to take this chance, lest I forget, to thank all professional groups, many major corporations, many academicians and universities and many interested persons for supplying to us over the past ten months a really large and excellent file of material on the general subject of objectives. Over this past week-end, I reread, again--for, I suppose, about the third time--the papers that are going to be discussed here during the next

three days. I think the quality of those papers is superb and unusually good for this kind of thing. The man-months or work that went into preparing some of them, I am sure, is a staggering contribution, and the entire profession should be grateful to those of you who have participated so sincerely and so well.

We are going to proceed immediately to the first presentation by the Financial Analyst Federation. They are already in place, to my immediate left. May I ask you, Bill Norby, to introduce your group?

MR. WILLIAM NORBY (The Financial Analysts Federation): Thank you, Mr. Trueblood. We are pleased to have an opportunity to participate in this proceeding. First, I'd like to introduce myself. I am William C. Norby, Executive Director of The Financial Analysts Federation; next to me is Dr. Frances Stone, Chairman of our Financial Accounting Policy Committee and Manager of the Special Products Unit and Research Department of Merrill Lynch; next to her is Frank E. Block, a member of our Financial Accounting Policy Committee, past Chairman of that Committee and a past President of the Federation. He is a Senior Vice President of the Girard Bank of Philadelphia. I notice also in our audience, we have Mr. Arthur Carlson, who is a member of this Committee and also Chairman of our Corporate Information Committee. In the back of the room, another member of our Financial Accounting Policy Committee--Marilyn Brown--down front, here, Gerald White of Sterling, Grace & Company.

First of all, I would like to state that since our paper, which was prepared by the Committee, was submitted to the Study

Group, it has circulated among the Directors of the Federation, and I have here a letter from our President, presented to Mr. Trueblood, which I will submit for the record, stating that all of the Directors of the Federation have approved the statement of the Committee. They believe it reflects faithfully the financial analysts' requirements for accounting information in making investment decisions.

I should note, parenthetically, that Mr. Parker, who is a Director of the Federation, did not participate in the vote since he is a member of the Objectives Study Group. Secondly, I notice in the back of the room that you have made a distribution of our recent statement to the Securities and Exchange Commission hearings on the hot-issues securities market. Our submission was entitled, "Disclosure Requirements for First Offerings of New and Emerging Enterprises." Since that statement was made in early March, the Commission has asked us for our further views on budget forecasts and first-offering prospectuses, and we have earlier this month made a short addition to that statement, outlining more specifically our views on budget forecasts and first-offering prospectuses-- and if I may I will submit that for the record also.

Now I'd like to ask Dr. Stone to make a brief summary of our position paper, and then Mr. Block's got further remarks he'd like to make in collaboration with that statement, and then we will be available for questions.

CHAIRMAN TRUEBLOOD: Thank you, Bill.

DR. FRANCES STONE (Financial Analysts Federation):

Both Bill and I obviously have written this statement, and we hopefully did it so that it would be endorsed by all of the Directors of the FAF.

I would like to emphasize the desirability, really, of full disclosure, so that we could have comparability in the reports which are turned out by companies. I would also like to emphasize our points on materiality, segments of the business, and interim reports equally as much. I think that perhaps we could have some help in the future on the whole business of social accounting and forecasts.

And in addition to my endorsement of our report--which is, as I said before, in part my own work--I would like to go a little further than that, and on my own personal behalf ask that perhaps the Study Group recommend that some experimentation be made in the future with current cost accounting, or fair value accounting, or however you would like to call it, but at any rate to stop this complete dependence on historical costs. The thing that cheered me very much in readying the paper was that there are a few other people around the accounting profession that feel the same way, and I do want to add my endorsement to their suggestion on this particular point.

That just about completes my own statement.

CHAIRMAN TRUEBLOOD: Mr. Block?

MR. FRANK E. BLOCK (Financial Analysts Federation):

I'd like to comment briefly on one of the areas on which financial analysts spend a great deal of time. I don't think financial

analysts have really expressed what they do in this area, in a formal way, nor have I seen it expressed very well in textbooks. However, there is an article in the April issue of The Journal of Accountancy that does touch on it; the title of it is, "Statement of Funds: A Glimpse of the Future?"

I think basically what the analysts are trying to do in getting at the concept of earning power is the careful analysis of cash flows. Now the cash flows that I am speaking of are not the sources and uses of funds, but rather the generation of moneys and whether those moneys have to be spent in a mandatory sort of way, to maintain the value of the corporation, or whether they are available for discretionary spending or distribution by the management of the corporation.

An example of this might be a company which needed to spend a million dollars a year on advertising merely in order to maintain the value of the corporation. If it spends any less than that, it is overstating the earnings of the company; if it spends more than that, presumably it is adding to the value of the company.

The same thing would be true in terms of research and development; the same sort of thing would be true in the relationship between depreciation and capital expenditures. Depreciation can overstate or understate earnings, simply because the necessary capital expenditures to maintain value may be more or less than the figure shown by depreciation.

So I think this type of analysis suggests that accounting might want to move in a new direction, with a new type of

sources of funds and uses of funds, breaking them down as to those which are mandatory to maintain value and those which are discretionary.

CHAIRMAN TRUEBLOOD: Thank you, Mr. Block. I noted in reading the papers generally that it was only your paper--well, not only your paper, but mostly your paper--which really hit upon this cash-flow situation. The Study Group, particularly because of Mr. Parker, has been very conscious of your position. It seems to me now that you are raising a quick question, however, which you are combining with cash flow which kind of relates as much to the classification of expenditures, present and prospective, as it does to the cash-flow issue, itself. Is that your intention, Mr. Block?

MR. BLOCK: Yes. I think perhaps this is an area in which study should be done and new ideas and new concepts, new formats and presentations, and so forth, would be most useful--for example, on the advertising question, how much advertising was spent merely to maintain position on old products and how much advertising was spent on new products--the same thing on research and development.

CHAIRMAN TRUEBLOOD: Would the Federation wish to extend its point of view on that issue, to include a different position than the profession, than the accountants have taken in the past about capitalization of such expenditures, or is it only a matter of classification that you are talking about?

MR. BLOCK: I think it's classification and information that we are looking for. I suspect, we would be very much opposed

to capitalization of these expense items. Now the traditional capitalization of items such as plant and equipment, of course, we would probably favor doing unless somebody comes up with a bright new idea of some better way to handle it.

CHAIRMAN TRUEBLOOD: So your desire for that kind of information is unrelated to capitalization, or you are indisposed to encourage further capitalization of intangibles as compared with past practices?

MR. BLOCK: Yes. I think the basic attitude of most analysts is that we automatically wipe out goodwill and capitalization of normally expensed items when we analyze companies.

CHAIRMAN TRUEBLOOD: All right, now, I have to alert the Study Group to guide me, and signal when they are ready. Mr. Gellein?

MR. OSCAR S. GELLEIN (Haskins & Sells; Member, Accounting Objectives Study Group, American Institute of Certified Public Accountants): Your paper puts a lot of stress on the notion of earning power. I wonder if I could ask you a few questions in that regard.

You make the point that it encompasses many things, starting with reported earnings, and you say that in most instances analysts will make adjustments to get "actual" earnings; then you talk about normality, stability, and the like, all wrapped up under the notion of "earning power."

Now, with that background, I've got a few questions. I think we all know some of the adjustments that you make. Could you comment on the conceptual nature of the adjustments that the

analysts make in going from reported to actual earnings, as you use the terms?

DR. STONE: I will start off, but I think this is the kind of question that should be open to everybody, because this is very crucial. The concept of earning power--and, we use the term rather inclusively, as you well realize--is an attempt, really, to find what is the real base for the corporation--how does it actually earn its money, in effect, and what kind of stability does that base have?

Did the fact that it just changed its accounting change its reported earnings? Now that is obviously not a stable base for what we are trying to find, and what most adjustments are designed to do is to lay bare, really, the real capacity as we can see it obviously from the outside of the corporation to continue to be a viable entity, to continue to earn profits, and at what kind of level can we foresee. The whole objective, really, is to have a base from which to project future income power.

MR. GELLEIN: Well then, actual earnings, having reflected some adjustments, reflect just a better measure of historical cost earnings?

DR. STONE: Yes, yes, that would be one way of...

MR. GELLEIN: A perfected measure of historical cost?

DR. STONE: A measure, really, of the historical--but, only as really, a means for moving forward, and the only way you can use past data is in this adjusted form; otherwise, I think you are badly hurt by the number of changes which have occurred over time and the additions and deletions.

CHAIRMAN TRUEBLOOD: I think Frank would like to add to that question.

MR. BLOCK: I think my answer would come out just a little differently than Frances'. I think, when you idealize normal earning power as being--it is the stability and sustainability of the discretionary cash flows--as I have described them before--available to management, either for paying out as dividends, liquidating or otherwise to shareholders, or reinvestment to increase the value of the corporation.

Now, this is the way I view it and I think there would be a substantial number of analysts who would hold that viewpoint. This does not in any way relate to historical costs.

MR. GELLEIN: I just have one final point, here. I noticed that, in Appendix "B" of your paper, the statement is made that what is really needed is the development of a notion of earnings related more to economic earnings on which both the analyst and the accountant will agree. I believe that's pretty much the way it's put. And then, later in the paper the question is raised as to whether historical-cost earnings mean anything.

Well now, the question I want to ask is this--you don't really like price-level adjustments too much, according to the paper. Fair value--well, you left the door open a little bit, but not too wide, for fair-value accounting. What in your view does it take to develop this better notion of income, whatever it is?

MR. BLOCK: There was an article by Jack Treynor, in which he was trying to emphasize that earnings, or earning power

had to have a viable economic concept behind them and that if you started with any system that required an estimation of the base at a beginning of a period and then subtract that from an estimate made, based at the end of the year, and called this "earnings," that you were involved in the process of circular reasoning and that you were unlikely to come up with anything that approached economic earnings and that some basic thinking should be done on just what "earnings" are.

CHAIRMAN TRUEBLOOD: May I ask for a point of clarification there, because your paper does talk about economic earnings, but the statement is made in your paper that, in general, you are opposed to the concept that financial accounting should report or should explicitly deal with such items as taxes, which may be deliberately imposed to affect the national economy, and so forth.

I have some difficulty, in your reaching for economic earnings and yet saying at the same time you do not think financial accounting should be used to adjust or report or influence the economy, as such. Is that not somewhat inconsistent, as a position?

MR. NORBY: I am not sure that I still get the drift of your question. It seems to me that our point with regard to the use of accounting to influence the economy is essentially a political issue. In other words, what we are doing in that instance, it seems to us is that we are calling "earnings" something other than what they really are according to economic terms, in order to make people feel good or induce certain political actions.

So I think, fundamentally, we do feel that that would mislead investors, that that kind of politically-adjusted earnings...

CHAIRMAN TRUEBLOOD: The distinction you are making is that financial accounting should not be used to affect the economy. But when you say you want a better presentation of economic earnings, you are really talking in terms of micro-economics, the macro...

MR. NORBY: Yes.

CHAIRMAN TRUEBLOOD: Is that correct?

MR. NORBY: Well, I think that what we are saying is that we don't want the standard of measurement changed, to induce--purely for political purposes--change in the economy; if the earnings are correctly measured and they have some effect on the national economy, why, so be it. But we are saying, we don't want the standard of measurement changed to induce political results.

CHAIRMAN TRUEBLOOD: I think Howie Wagner has a question.

MR. HOWARD O. WAGNER (Jewel Companies, Inc., Member, Accounting Objectives Study Group, American Institute of Certified Public Accountants): Yes. In your paper, you also mentioned--again going back to the development of a purification of earnings power--the fact that segregation of income or disaggregation, whichever you call it, would be also very useful. Could you amplify at all your ideas with respect to disaggregation of earnings? This is a subject that means different things to different people. Since one of the purposes of our getting together today is to put all of these things out in the open,

I personally welcome any comment you might have to offer in connection with this.

MR. NORBY: Well I think that the concept stems from the fact that, today, we have companies which are in many different fields of endeavor, and since the objective of the analyst is to relate the company to its environment in order to make some estimate of the future potential, when you have a widely diversified company it becomes very difficult to do. So it is necessary, therefore, to break it down into its separate elements that respond to different economic environments.

Now how any particular company would be disaggregated depends pretty much on the judgment of the situation, since there is no uniform pattern of diversification, and this apparently is one of the difficulties of coming up with an Accounting Principles Board Opinion, because it's hard to write a definition which will cover all circumstances. Sometimes we are dependent upon the market in which a company sells, sometimes dependent upon geographic locations; sometimes we are dependent upon different manufacturing processes and different enterprises--so, it's the different parts of the company that are affected by wholly different cause effect factors, different marketing factors, and so forth.

Now the extent to which one allocates joint costs to these separate segments is another thorny issue. We do not insist that all costs be allocated. This becomes sometimes an artificial process, when you get down to certain broad overhead costs; however, we think the process can go fairly far--at least

far enough so that analysts can measure the relative impact on total earnings of an activity in different segments.

Actually, I think a good deal of progress has been made and in the reports this year at least in the annual reports so far published--a good many companies seem to be making some pretty good representations in this field. We think there is probably need for more explicit accounting definitions of how they arrived at the figures--a better explanation of the segments--but a fair amount of progress seems to have been made.

CHAIRMAN TRUEBLOOD: Are you, then, in general support of the current Securities Exchange Commission requirements on segmented reports?

MR. NORBY: Yes, when we think it's absolutely essential for our work.

MR. BLOCK: I will carry it one step further, saying we need just as much information about a segment as we do about a corporation making precisely the same products, because we cannot compare the two unless we have comparable information all the way up and down the line--which says, for the segment, we need a balance sheet statements of sources of funds, income statements, footnotes and the whole thing.

CHAIRMAN TRUEBLOOD: Are you familiar by any chance with the NAA's position paper on reporting for diversified companies, in which they use the phrase, "traceable costs," in order to make the allocations between lines?

MR. BLOCK: I am not familiar with it, but I am familiar with running a department for a long period of time, and while I

know managements very often say there is no possible way to trace costs, allocate them, and so forth, I have always been told that if I didn't make a profit on a total income statement from my department I was going to get fired.

CHAIRMAN TRUEBLOOD: Do you have any further questions on this subject, Howie?

MR. WAGNER: No.

MR. NORBY: Bob, we'd like to make a further comment on it.

CHAIRMAN TRUEBLOOD: Yes--Frances?

DR. STONE: I do want to say that the whole area of segmented or diversified-corporation problems is one we have been involved with for now a number of years, and I think the Securities Exchange Commission has made a large step forward for us by requiring this kind of reporting, and it is vital for doing the sort of forecasting which I talked about before and which we were looking for--earning power.

And may I also say something about the differences that seem to arise in our paper? We interviewed a number of securities analysts and found that there wasn't much support for price-level or fair-value accounting. I think that we have a group within the analysts' profession who are conservative, just as you have them among the accounting profession, and I think that we were expressing in that set of statements, their opinion, at that point.

CHAIRMAN TRUEBLOOD: Well...

MR. NORBY: Bob, on the question of the NAA traceable costs, Frances Stone and I did participate in a couple of hearings;

we heard that: the idea sounds interesting, in theory. We didn't feel we had enough definition of it to know just what was actually involved, how far down the line it should go toward net income. It seemed that it could be quite variable from one company to another in its application and therefore was a little uncertain.

CHAIRMAN TRUEBLOOD: I agree, Bill, that the definition in the paper is not very explicit to this point. I understand, however, it is a discussion paper, as distinguished from a position paper. Don Edwards?

DEAN JAMES DON EDWARDS (University of Minnesota; Member, Accounting Objectives Study Group, American Institute of Certified Public Accountants): Bill, under your section "Objectives and Financial Statements" in your paper, Item 22, you state that financial statements should be keyed to the interest of the professional investor. Would you like to comment about that as it relates to the current published information on the objectives of financial statements, and the audience to which they are addressed?

MR. NORBY: Well I think our point was that, one, there is a lot of glib talk about "thirty million shareholders," and so forth. We don't feel that the understanding of financial and economic processes is sufficiently broad, wide-spread, that one should gear financial accounting objectives to that group. We think that you have to gear it to a somewhat more sophisticated audience--an audience, not of accountants, essentially, but of people who understand economic and financial matters. And because business is simply too complex today to boil it down to a few simplistic statements, we believe that it's the function of the financial analysts,

among others, to reinterpret this data for the broad investing public. We think that the corporation itself, of course, can have two-level-type reports; it can have some summary figures which perhaps meet the basic need of the average investor, and then its actual report should be to a more sophisticated audience.

DR. STONE: I think that if you ever ask a small sample of thirty or more investors whether they have read annual reports, I think that you would find that a large percentage of them have never even taken them out of the envelope to look at them, so that in effect I think your real audience for the statements are the analysts, portfolio managers, the professional group that we feel we represent in the FAF.

MR. GELLEIN: I had a similar question, also. In Section 3.6 you in effect say that the corporation is too complex to reduce its financial statement to any simple analysis--and then you go on to say that the report might show the simple first and then parallel that with that which it is required to expand.

My question is that if you cannot reduce the complex to the simple, then is the simplified statement meaningless or is it even misleading in your view?

MR. BLOCK: It well may be both meaningless and distorted, but I am sure that the stockholders who are not sophisticated still want to hear something from the managers.

MR. GELLEIN: Even though they don't open the envelope?

MR. BLOCK: Well some of them do open the envelope I am sure, and some of them do fly over the first few pages. My wife opens the envelope, turns to the first page and looks and

sees whether it says earnings were up or down; if they are up, she is happy; if they are down, she asks me about it, which is the extent of her interest in the matter. I think she might be quite typical of most individual stockholders.

I think the management could do a better job of communicating those simple things, but here I think it's a question of how management is going to communicate with that particular group. I think that's a managerial problem. We realize that in their simplification they are going to create distortions, and there is nothing we can do about that, but we think it very important that adequate information be provided for professional investors. And of course there are many individuals who are quite professional in their approach to investing, and they may want the same information.

CHAIRMAN TRUEBLOOD: We have a question from the floor, about whether you would elaborate on your position about publication of corporate forecasts, which gets into an area on which I think we should have some statement from you on the legal side. These days, the trend of court opinions is distinctly, "information to one must be information to all." In some of our group interviews, very responsible parties have suggested that information to the public might be in separable pieces--one, the simplified; one, the equivalent of a 10-K; one, the puffing president's letter; and one, supplemental data. But you, in your role as analysts, are really the prognosticators these days; you give to the public your judgmental and sophisticated conclusions about earnings prospects. And yet you have historically come by this data

by a kind of contact not available to me, as an investor, or to even the institutional investor.

Would you care to comment about forecasts, generally, as well as this legal-privy problem?

MR. NORBY: Well on the subject of forecasts generally, we cannot give it as much attention in this paper because we regard this as a problem in corporate disclosure rather than a problem of accounting objectives. We see the study of accounting objectives as trying to determine the best way of measuring earnings and other financial aspects of the business. The forecasts of those elements in the future doesn't impose any new standard of accounting, it seems to us, but does involve a question of the proper means of disclosure.

The whole subject of formal corporate forecasts is now an issue in the public sector; the Securities and Exchange Commission has announced that it is studying the issue, and recently the Chairman indicated he was going to try and have a decision by November. A number of organizations are providing input, or hope to, to the Securities Exchange Commission, and the Financial Analysts Federation does want to provide its input.

I would say that at the present time the views of analysts on the utility of corporate forecasts is quite mixed. Some may be surprised, but the analysts are not the ones who have been pushing the subject of corporate forecasts. So, pending a progress study of the Federation opinion, I am not at liberty to say how the analysts feel about this.

Now as to the particular issues of the legal means of

disclosure, I think that there is much to be done in this area. However, our position is certainly that information should be available to the general public. We don't seek any special privilege in securing information by the forecasts. It is true that in particular cases analysts do discuss forecasts with management. However, management is responsible for making full disclosure, and in the recent celebrated Bausch & Lomb case, we did have an issue which does get at this. A suit has been filed claiming Bausch & Lomb revealed its forecast to a particular analyst who acted on it, and therefore was in the category of "insider." This forecast was in substantial variance with the previous expectations in the Street.

I don't want to prejudge the conclusion of that, but, if the facts as stated are true, I think there is no question that the analyst was privy to inside information, and I don't think other analysts or the Federation would support that point of view.

Incidentally, in our new Financial Analysts Journal, which I just got a copy of this morning, we have an extensive interview with Commissioner Loomis of the Securities Exchange Commission clarifying a lot of these things on a current basis.

CHAIRMAN TRUEBLOOD: Now, if an objective of financial statements were to be--and, we have no conclusions at present--that they should be useful for predictive purposes, in the accounting sense or in the economic sense, as you look at it, do you feel that the bulk of your members would be satisfied with purely historical information?

MR. BLOCK: I think that the analysts would be quite satisfied if the historical data would provide us a basis for forecasting the future. However, I would go a bit further by saying that if the financial statements do not provide a basis for predicting the future, then they are of interest not to analysts but to historians.

CHAIRMAN TRUEBLOOD: So, there must be some forecasting or data useful for forecasting, in order to satisfy the purpose of your group?

MR. BLOCK: Yes, sir.

MR. NORBY: I think that's an important distinction-- that is, not a forecast in itself but its providing useful information. I think we use the analogy in the report, here, that if one gets a personnel report on somebody, that has to be accurate in order to make a judgment from that source about how that person might perform in the future. It's the same thing with financial statements.

CHAIRMAN TRUEBLOOD: A very helpful distinction.

DEAN SIDNEY DAVIDSON (University of Chicago: Member Accounting Objectives Study Group, American Institute of Certified Public Accountants): Is this anything likely to be more useful to use; to make a forecast of management's view of what's likely to happen in the next year?

DR. STONE: I think that that would be extremely useful and in fact that is usually the result of an interview with management, and that is where, obviously, all of the problems have begun to arise. The interview between the analyst and the management

will develop a basis for a forecast and will even in some instances get an expression of the opinion of the management as to where they think the results will come, so that what you are saying is that they would publish the information which is generally developed.

DEAN DAVIDSON: Yes. Is it appropriate for an individual analyst to have that information and the rest of the public not have it?

MR. BLOCK: No.

MR. NORBY: No. We don't claim that it is. Now a succession of analysts might interview management, and they will come up with their estimates which are about the same, and each one is confirmed in time--which is how you get the phenomenon known as the "Street estimate." I think we should point out that forecasts are made available in many different forms. One only has to read the daily papers to see that a half dozen managements a day are forecasting earnings--there is nothing new about the idea. I think there are a lot of people who are afraid of how management might use it, though.

DR. STONE: I think publication of the forecasts is not the problem, because certainly every brokerage firm who turns out a report on the company will have a forecast in it, and I would guess, most of the time, that the forecasts have been checked, in some form, with the management, so it kind of represents management's thinking, as well as the analyst's.

CHAIRMAN TRUEBLOOD: Except, in the case of the Wrigley affair.

DR. STONE: There are a couple of items I might cite.

CHAIRMAN TRUEBLOOD: Two more questions. Then we must go on. Reed Parker, first, and then Frank Weston.

MR. C. REED PARKER (Duff, Anderson and Clark, Incorporated; Member, Accounting Objectives Study Group, American Institute of Certified Public Accountants): I'd like to get back to the subject of fair-value accounting; we will have a good deal of testimony on that. I wondered if, to set the background for that, you could repeat for us the two reasons why you felt numbers of analysts did not find this useful, and also if you'd say from your personal experience, given the fact that analysts have ready access to all the price indices that are and have been available--and, to my personal knowledge, many of them have a good deal of mathematics background and would understand the methodology of discounted cash flows--to your knowledge, are there any or many who have found it useful in their work to use these procedures?

DR. STONE: I guess, since I have raised the topic, I have to answer the question. I think, number one, the reason why most analysts have objected to fair value or current cost accounting is that it would not be comparative with previous data, that it would open up an entirely new way of looking at the items on the balance sheet, and, obviously, through the income statement as well. That seemed to me to be the biggest objection in the testimony that I read of the interviews that were conducted.

As far as your suggestion for using indices as a basis for adjusting the statement, I have tried this myself, and it is a difficult if not impossible task since, number one, you really

do not have enough information as to the kind of inventory or when the value was put on the balance sheet, particularly in LIFO accounting for inventory. As far as the equipment is concerned, and buildings and all the rest of the fixed assets which a corporation has, I really defy anybody outside of the corporation to adjust these for price level or current replacement cost. I have tried this in looking at sales of a corporation.

MR. PARKER: Frances, aside from your work, do you know of any analysts who have used any of these procedures and found them helpful?

DR. STONE: I think I have heard about some of the analysts attempting to use an index as a way of looking at sales. Particularly, there, I think you can try to see whether a corporation has had an increase in sales primarily because of price increases or because of real growth--and there, perhaps, you can get some units.

MR. PARKER: Do you have responses in the questionnaires of analysts using the fair value procedure?

DR. STONE: I don't think we did.

CHAIRMAN TRUEBLOOD: I think our experience with the research that went by ARS No. 6, in which your company participated, Howie, would be that, for any definitive uses, this kind of analysis must largely be made internally, because any external group simply would not have the required data.

We must move on to Frank Weston, and then close this.

MR. FRANK T. WESTON (Arthur Young & Company; Member, Accounting Objectives Study Group, American Institute of Certified

Public Accountants): This question happens to be in the same general area. On page 23 of your paper, you have described or discussed the fair value accounting notion and observed that it's appropriate if fair value could be determined; it would be useful since it would be closer to economic reality even though it might require some restructuring of the financial statements. Many of the papers submitted to our group observed that there is no great ground swell for fair value accounting outside of a few academic circles, and my question therefore is, would the Financial Analysts Federation recommend to us that we consider seriously the advantages and disadvantages of fair value reporting, as outlined on page 23, despite the fact that there is no great expressed need for it among the analysts or others?

MR. BLOCK: I think we would give very strong support to further research in this area; however, I think the usefulness of the concept at the moment is somewhat limited. Basically, there are two concepts. One of them is measuring management's accountability for the preservation of constant dollars of assets over time. That's one viewpoint. The other one seems to be very much more of an appraisal type of viewpoint. The appraisal viewpoint means absolutely nothing unless those assets are going to be sold. In most cases, they are not; they are going to be used up. A rare exception would be land, but the buildings and equipment generally aren't sold; they are used through their economic life and then disposed of for relatively fractional amounts. So appraisal values do not mean very much to us because most companies are not liquidating.

When you get into inventories, that's a different question, and we certainly would like to have more information on the true value of inventories.

CHAIRMAN TRUEBLOOD: Thank you very much. The analysts have met with us, have cooperated significantly with us. I think their paper is superb, and your presentation and your patience in your presentation have been remarkable. Thank you.

MR. NORBY: Thank you.

DR. STONE: Thank you.

CHAIRMAN TRUEBLOOD: I hope you will be able to stay and feed us some questions from the floor as other witnesses appear.

Next we have J. K. Lasser & Company. And could I remind the audience that as questions come to your mind, if you would write them out and give them either to Mr. Streit, Mr. Shannon or Mr. Gans; they will be brought up here very promptly and they will be taken care of.

Arnold, will you introduce yourself and your position, please?

MR. ARNOLD I. LEVINE (J. K. Lasser & Company): I am Arnold Levine, National Executive Department, Management, of J. K. Lasser & Company, and I have with me today Dick Nest, who is with our National Audit Department. Gentlemen, it is a pleasure to appear before your Committee and have an opportunity to expand a bit on our position paper. As you know, our paper was previously presented to you in unedited form; it is now in the process of revision and will be delivered to you shortly. I do not plan to discuss our paper in detail--you all have copies

of it--but I thought it might be well if I briefly summarized our firm's various recommendations.

We believe that the major, overriding objective of financial statements should be their usefulness to the reader. Based on this proposition, we have considered all of the various kinds of users of financial statements and attempted to analyze their needs. This analysis has provided the basis for our recommendations, which we believe in most ways not only meet the need of these users but are fundamentally practical as well.

Our recommendations do not solve all of the problems of financial reporting by any means, but we believe they are a step forward in the evolution of better financial reporting. We feel strongly that there is a need for financial statements to present historical events with presumed identical underlying conditions in terms representative of the future. We likewise recognize that no single financial statement presentation can serve all of the various user groups and still meet the objective of being useful to each. Historical-cost-basis financial statements which are presently the norm for presenting financial data, in our opinion, continue to have a useful reporting purpose, both from a stewardship approach and as a foundation for the basic financial record and statement. However, we believe that current value reporting is also essential to make the statements useful to a large segment of users.

Current value statements would have the benefit of presenting financial data at amounts encompassing present economic realities, in particular, as well as the ever-changing purchasing value of the dollar.

We have considered the alternative approach of price-level reporting, but believe current value would be more practical. It is evident that contemporary professional literature and thinking may also be moving in this direction.

We are aware that determining current values and the related questions of auditing will present problems, but we believe they are surmountable. The presentation of current value in financial statements, along with historical-cost statements, in our opinion, would be a proper approach to moving toward the objective of usefulness. As a result of our study, we have also concluded that priority should be given to research in the area of projections. Though historical cost and current value statements are useful by themselves, we believe they do not provide all of the necessary information and data required to aid users in the decisions they wish to make, as investors or credit grantors, and so forth.

Projections of what may be expected to occur in the near future, under certain assumptions, are needed by many users. Again, we recognize all of the arguments as to why projections should not be presented but we believe that many of these objections are only objections to change itself. In our opinion, the accounting profession has the capability to research this problem and to establish the necessary standards by which projections may be prepared. The reader will have to make personal judgments on the projections, but if the assumptions and standards are clearly disclosed, the financial statements will have performed their function of presenting useful information.

In connection with the portrayal of current values, we recognize there are certain items which may be very difficult to reflect, such as goodwill, research and development costs and certain other deferred costs. We therefore recommend that consideration be given to a separate or supplementary statement for the purpose of segregating these items from the basic current value financial statements. Such an approach would also aid the reader in comparing companies within the same line of business, by removing these items of non-comparability.

With regard to product line reporting, we see little ultimate benefit to be received by users. As the pressures mount for more and more refined reporting on distinct product lines, such tailored reporting may well overshadow the overall entity's operating performance. We believe the solution should be one of using broad business lines to provide this type of information to readers. Practicality is a major consideration.

Our last subject deals with multiple year reporting. We recognize that in many annual reports, multiple year results of operations and other data have been given; however, more complete comparative financial data should be provided to aid readers in understanding trends, growth, and so forth.

We do not consider our position paper to be a panacea for all reporting, but we believe that it contains elements upon which better financial reporting can be built. Further, we recognize that our suggestions cannot be adopted without extensive consideration and research. But, again, we feel they do point a way to better financial reporting which will help meet the prime

objective of all financial statements--usefulness. Thank you.

CHAIRMAN TRUEBLOOD: With respect to your position on fair value--and apart from price-level-adjustment value which has been researched, I think, more adequately by the Institute to this time--you should know that we have ongoing investigations--not to the depth, I think, that would please you, but we do have ongoing investigations -- which will be input for the Group, on discounted cash flows, replacement values and exit values, just as three of the most talked about alternatives. Do you take any particular position as to preference in these more far-out approaches?

MR. LEVINE: Well, we are aware, of course, that you are undertaking this type of research, at least to some extent. I think that we did indicate in our paper that we did not take a particular position with regard to any one of those particular methods. We do feel that there is merit probably in each of them. Obviously, the considerations that will have to be given are practicality and the ability to be objective in solving them.

I think if there is any one justifiable argument against fair value accounting it's the ability to achieve it. And, obviously, if we can find a way to achieve it I think many of us would immediately rise up and find that we would be in support of it.

CHAIRMAN TRUEBLOOD: But could you please link this with your distinction among the interests and desires of users? You might come to the conclusion, for example, that exit values were more appropriate in an accountant's situation, whereas replacement values might be more appropriate for the purposes of other users.

MR. RICHARD A. NEST (J. K. Lasser & Company): I don't think we'd find that, Bob. I think our position would be that at the present time current value would be the thing, but if research does show areas where one would be better than the other we would not be opposed to it.

CHAIRMAN TRUEBLOOD: You are talking about price-level, adjusted?

MR. NEST: No--basically, more toward the appraisal approach.

CHAIRMAN TRUEBLOOD: Sid Davidson has a question.

DEAN DAVIDSON: If your move toward current value could not be accomplished in one quick step, would you prefer to have certain items placed on a current value basis where that can be done in a satisfactory manner, leaving others at historical cost, or would you prefer to do nothing until you can make your complete adjustment?

MR. NEST: I think our position definitely would be a step-by-step approach, given recognition that to go directly to a current value basis as a separate statement may not be able to be done in one fell swoop. That's why we said there are limitations and problems. We would definitely be in favor of a step-by-step approach if that were the only practical approach to it.

DEAN DAVIDSON: So that you would wind up with a statement that was part historical-cost base and part current value?

MR. NEST: I think at least my personal opinion would be that to go to something that's better than what we have is a better approach than to just stay where we are.

MR. LEVINE: I think, actually, we have suggested that in the event that consideration is given to fair value--and we certainly hope that it will be--that it would be of significant value to the informed public. It has experienced in the past a combination presentation. To move immediately in toto, to fair value I think would present a different kind of a problem, based upon past knowledge of the user.

CHAIRMAN TRUEBLOOD: But that is to say that the step-by-step approach you would regard as transitional--that is, you do concede that, ultimately, it would be a restatement of the whole...

MR. LEVINE: We concede that that is a possibility. I think that time would be the best judge of that. We recognize that it very well could be.

MR. WESTON: On page 26 of your memo, you talk about property, plant and equipment, and discuss the various methods of valuation and end up by saying that an appraisal would be the best method to use.

Now, I just observe that an appraisal must be based on some approach to the assets, and we might like to hear you describe that. But how will you respond to the comment from the previous group that carrying property, plant and equipment at fair value, since it will not be sold, is not useful?

MR. LEVINE: Well, I'd like to respond in the extreme. Two companies with exactly the same businesses and same plants but one fully depreciated and the other just previously acquired would reflect totally different operating results, as we reflect

them today, as we are now portraying. Yet, as a practical matter we recognize there would be a significant difference in the underlying business itself.

I think the problem that relates to the analysts as I see it is that this approach does not have much meaning in the atmosphere that we live in, today. To use this information and then have it portrayed, in the final analysis, on a historical basis and have earnings per share related to historical costs, is going to dictate that the public is going to measure it in that form, and therefore it won't have any value today.

CHAIRMAN TRUEBLOOD: All right, you have a question? Go ahead.

MR. PARKER: I am just going to ask--on page 18, you have introduced your discussion of current value accounting by saying that the most common complaint of users about financial statements is that they do not state current value. We had some indication from at least one group of users--the analysts--that this would not appear to be their most common complaint. What kinds of users were you thinking of, and what kind of evidence suggested that you make that statement?

MR. NEST: I think this often comes up just from our own clients, when we get into problems of accounting.

MR. PARKER: Your clients would be managements?

MR. NEST: Managements, shareholders.

MR. PARKER: Shareholders?

MR. NEST: Shareholders, definitely. We get into the question of buy-sell agreements, where we go into the question of

values. It's very nice to say that cost is a fine figure to work with. But as soon as you get into questions where the company has any financial problems, it's amazing how quick current values come to the fore in any technical discussion. So we just believe that a problem is that the cost statements don't give the information. And this is a problem.

MR. LEVINE: I would also say, Reed, that the cash flow statement has been an attempt to solve that particular problem on the part of the analysts; we all recognize that as a factual matter. The income statements, themselves may not be in some cases--maybe, many cases--as meaningful as the cash flow statement, and the cash flow statement I think is really an effort to overcome the problem related to historical costs.

MR. PARKER: Right, Arnold but I would gather the cash flow statements are based on a transaction basis, are they not, whereas I would gather the current value adjustment would state things that did not occur as a transaction.

MR. LEVINE: I agree. I am only saying that for the problem that relates to this particular situation the analysts today are using the information that is available. Obviously, we are married to certain conditions. In a free society, starting from scratch, it's very difficult to evaluate what is the best, and I am a firm believer that moving to this particular approach would help solve that now.

MR. PARKER: How do you feel this would be helpful in making an investment decision, for example; what would it improve, or how would it help?

MR. LEVINE: Well, I believe that there is a difference between the economic earnings and the earnings as portrayed. And I think that in the final analysis, not on a short-range basis-- a part of the problem in investment analysis relates to the short term--but on a long-range basis, I think it would have significant value; it would better portray economic earnings.

CHAIRMAN TRUEBLOOD: May I, Reed? A number of papers-- and, yours is not the only one--have indicated some preference for some kind of value adjustments. I remember particularly, in a couple of papers that confined themselves to price-level adjustments, that, given our relatively stable inflation in this country-- and, I use the word "relative" deliberately--perhaps an adjustment for price-level changes every ten years would be indicated. But we do have precedents overseas, in different kinds of economies, for a current value approach fairly close to yours, going beyond price-level.

Do you think it conceivable then that an objective might ultimately be to do the research and make the adjustments transitionally that will ultimately bring us to a current value statement of balance sheet items, whatever that means, or however we resolve it; do you think of that in the objective context, as distinguished from the approval context?

MR. LEVINE: Well, Bob, we haven't thought of it in that form. Obviously, we couldn't quarrel with it. I think that we would be very happy to see such an approach being given consideration.

CHAIRMAN TRUEBLOOD: I have one question from the floor

which I want to get in before our time has gone. The question from the floor has to do with the analysts' rather strong position that a company must hold individual departments responsible for profit and that in terms of usefulness for their purposes, product line reporting is not only significant but almost required, whereas the writer indicates that the tenor of your paper seems to be that product line reporting may be good but not very practical or possible.

Would you care to respond on the matter?

MR. LEVINE: Well, Dick might want to say something about it. We are not simply in disagreement with product line reporting. I think it's a matter of degree. We are in favor of a broader business line because we think it is an important practical approach. Our concern with product line reporting is that it might become refined to a point that it will be impractical, that it will be uneconomical to provide for it; wherever it is provided automatically within the business it would probably relate to business lines and, as such, would be a segment we would find compatible with the analysts' viewpoint.

CHAIRMAN TRUEBLOOD: Dick?

MR. NEST: We also believe that as long as you have a conglomerate or group of companies working together as components, that to bring it down to a net earnings figure, an individual one, is an impractical idea because there are things that aren't done between companies and there are things that are done between companies that make it impossible to really review them as to their realistic values to the group.

CHAIRMAN TRUEBLOOD: Well, given the impracticality and the difficulty, would you object to an objective which was to say something like "to the extent practicable, divisional or segmented reporting should be made available to the public?" Does your concern run that far?

MR. NEST: I don't believe our concern does run that far, Bob. I don't think we would object to it, but I think we would find it questionable that the general public needs that fine a breakdown.

MR. GELLEIN: Let me say first, I thought your paper was very well organized and put together.

MR. NEST: Thank you.

MR. GELLEIN: And, on page 31, I'd like to ask a question about this third statement, that middle paragraph, Dick, on that page. It in fact comes to the conclusion that those assets for which current value is not readily determinable would be shown in a separate statement and not included in the balance sheet or in the income statement. I don't quite see how this works. In other words, let's say we incur a cost to acquire a patent right and that is its current value when purchased. Let's say that a year later its value is not readily determinable. How does it get over into this other statement?

MR. NEST: Basically, Oscar, I believe the focus was there on the current value statement. The way it reads it led you to the conclusion that it's the cost statement. We didn't mean to imply that.

MR. GELLEIN: Right. Do you conceive, in that regard,

Dick, that intangible assets generally would be there?

MR. NEST: That's right, definitely.

CHAIRMAN TRUEBLOOD: Another question from the floor: "Why must current value accounting and general price-level accounting be considered as mutually exclusive alternatives? Both have separate objectives and both can be reflected in the same financial statement simultaneously, in the writer's view."

I think I contributed to that confusion myself, by saying we were not proceeding with research, in our Group, on price-level adjustments because we thought that had been previously done. Now, do I gather, or will you answer the question for me--do I gather that you did not intend, in your presentation, to separate them, exclusively?

MR. LEVINE: Well, we aren't enamored with price-level accounting as such. We don't feel from a practical viewpoint that it has significant value compared with the costs of obtaining the information. We don't feel that, as we have indicated, unless there is a more significant adjustment in the price-level from year to year and over a period of years, that in essence this would be meaningful. That's our position.

CHAIRMAN TRUEBLOOD: But, in terms of the question, I rightly interpret your comment not to treat price-levels, generally, as a mutually exclusive alternative?

MR. LEVINE: That is correct.

CHAIRMAN TRUEBLOOD: Sidney.

DEAN DAVIDSON: In talking about the usefulness of statements, the second major change that you recommend is the one

concerning projections. As I read your materials, I wasn't quite clear on two items there. It seemed to imply that such projections should be covered by an accountant's opinion. And if that is correct, I was not clear on whether you felt the opinion should relate to the basic assumptions underlying the projections as well as the method of compiling the data upon those assumptions, or whether you preferred to have them relate only to the compilation of the data.

MR. NEST: We recognized at the time we were writing this that we were working into an area where it's a never-never land today. But we see as an ultimate that we would cover both the projection and the assumptions as our goals in the future, yes. We would like to go all the way on this. We recognize that standards don't exist, today--the standards of deciding what those assumptions should be--nor do the standards exist as far as the auditor's opinion on it. But it's our belief that this is where we should be headed, and where we believe we probably will end up.

MR. LEVINE: Let me add just one statement in that regard. We attempted, in presenting a paper in connection with the objectives of financial statements to divorce to some degree--at least, the degree that we possibly could--the auditor's responsibility. Nevertheless, we also recognize, as we have indicated in our paper, that one of the important attributes of financial reporting would be verifiability.

We feel that the profession is able to find a proper ground on which an opinion can be rendered regarding projections. It may require assumptions but we feel it can be done.

DEAN DAVIDSON: Earlier you suggested a sort of step-by-step approach with regard to fair value. With regard to projections, would you be willing to accept that step-by-step approach, to initially have only the compilations covered by the accountant's opinion?

MR. LEVINE: Well, I would like to say this--that, as far as our firm is concerned, we would accept anything that moves in the right direction. We do not expect that these are things that are going to be done overnight.

CHAIRMAN TRUEBLOOD: May I ask you on that, just as a clarification, in your research did you happen to determine the practice in England? Am I correct that the chartered accountant takes a position both on the compilation and the assumptions in the United Kingdom--is that correct?

MR. NEST: Talking off the top of my head, I just can't recall it right now but I believe it does. But I am not sure, Bob. I don't recall, right now.

CHAIRMAN TRUEBLOOD: Reed has an extension on this question.

MR. PARKER: To ask if the accountants are to pass upon the reasonableness of the assumptions underlying the forecast? I would assume this gets into various economic factors, politics, foreign affairs and labor relations. Is there something special in the accountant's training that makes him competent to say whether management's assumptions are reasonable or not in that area? And if the accountant does assume that role, some of the other submissions that we have raise the question as to the potential conflicts

of interest that then enter in if the accountants come around and audit the results based on the forecast.

MR. LEVINE: Well yes Reed, I think the significant word there is "reasonableness." I don't think that the accountants are particularly qualified to give an opinion of the assumptions, per se, except perhaps in the negative form. But here again I think that this is a question that can be researched and determined as to the degree that the accountants' responsibility can take.

MR. PARKER: Well, for an example, many forecasts would be resting on some kind of assumption of the rate of change in the gross national product--real or before price-level adjustments. Does the accountant, by his training, have special knowledge...

MR. LEVINE: I don't think so.

MR. PARKER: ...as to whether it would be large or small?

MR. LEVINE: I think the answer is "no." He would have to rely on other experts' input.

MR. PARKER: But he would pass a judgment, based on that other expert input, as to whether or not the management was making a reasonable assumption?

MR. LEVINE: Well, perhaps. I really would prefer not to answer that in the affirmative because I am not sure that that's the way it would be coming out--but it's possible.

MR. NEST: Could I comment a minute there, Bob, on this question of conflict of interest, or later auditing? This is a common ghost that is thrown into all conversations when we move into new areas. It seems to me every time we issue a certificate

on a balance sheet that has an inventory we are making a forecast that that inventory will be realized, and then we go in next year and audit. I haven't heard anyone yet say I should not audit next year since I have already passed on a balance sheet. I think this is something that does not bother anyone, and I think we should be able to defend ourselves on that very easily.

MR. GELLEIN: The question I have is a little different. In your paper, you make reference to the qualitative objectives set forth in Statement No. 4 of the Accounting Principles Board such as relevance, comparability, understandability, and the like. My question is whether you have any views about whether to make them operational or at least more operational it's going to be necessary to rank them. Which one takes over if you have two qualitative objectives that you are trying to meet and they're in conflict--let's say verifiability and relevance, or pick any two.

MR. LEVINE: Well, we haven't thought about it, Oscar, but I think it has a lot of merit. I think, in the final analysis, we may have to face up to what is more important and what is less important, in coming to the conclusions that are most meaningful. Again, we used the word "useful" as being the ultimate, in the final result.

MR. NEST: I may be able to eliminate one or two of them for you, Oscar.

MR. GELLEIN: Good!

MR. NEST: If you want more than one or two, I'd be in trouble.

CHAIRMAN TRUEBLOOD: George Sorter passed to me an item which I believe is from the accountants in England. The statement is made that profit forecasts must be compiled by the directors with the greatest possible care; the allocations and the bases for the forecasts must be examined and reported on by the auditors or consultants to management.

DEAN DAVIDSON: But my understanding of the way opinions in the United Kingdom run is that they speak of the assumptions for which the directors assume complete responsibility, so that the assumptions, as I understand it, are not covered by the accountant's opinion in the United Kingdom. The proposal that is being made here is a substantial expansion of what is currently being done there.

MR. LEVINE: Well, if we have implied that or stated that, in total, I would hate to get hung up on that because I don't think that that is what we consider to be important. What we consider to be important is the fact that it be done.

As far as the auditor's opinion, we recognize the need for proper research in determining how it should be done. We would certainly abide and welcome management assumptions, if we were able, in the final analysis, to have that presented. Nevertheless, we feel that the accountant should at least bear a negative responsibility in regard to those assumptions.

CHAIRMAN TRUEBLOOD: All right, thank you very much. And I should remind the audience that Arnold is very conscious of many of your problems because of his excellent and deep preparation in the Wheat Committee report. Again, your paper is fine, and

thank you very much.

MR. LEVINE: Thank you.

CHAIRMAN TRUEBLOOD: Alexander Grant? Will you introduce yourself please.

MR. CHARLES WERNER (Alexander Grant & Company): Mr. Chairman, I am here to present testimony on behalf of the partners of Alexander Grant & Company and in particular I am here to testify on behalf of our Executive Partner, Wallace Olson, who is a member of the Wheat Committee and who deeply regrets that he can't be with us this morning. Unfortunately, our international executive committee is meeting in Montreal today and tomorrow, so I am here in his stead, and I hope I will be acceptable to you.

My name is Chuck Werner, and I am our firm's Director of Technical Services. We will confine our remarks this morning to two issues on which we believe our firm's views differ substantially from many of our professional colleagues. These two issues are whether general purpose financial statements can and should be designed to serve as an adequate means of communication with the untrained user and, secondly, whether the present form of attestation, the standard short form report, should be revised.

In our written testimony previously filed with the Study Group we said that we believed that it is not feasible to design either general or special purpose financial statements that will serve as an adequate means of communication with the untrained user. It is our view that no attempt should be made to achieve this objective but that general purpose financial statements should be so designed that the trained financial analyst or investment

advisor has sufficient information to properly advise the untrained user. We can easily picture the confusion of a Maori tribesman suddenly confronted with a population concentration of cities like New York, Chicago and Los Angeles. We believe that the untrained user is faced with a similar "cultural shock" when he attempts to read and understand financial statements.

It has become fashionable to cry out against accountants for their failure to make financial statements more understandable. In the attempt to respond to this outcry, the accounting profession has allowed itself to be trapped by the delusion that the performance of a complex business enterprise can be reduced to one statistic--earnings per share.

A recent study by Georgeson & Co. reveals some interesting facts about untrained user's attitudes toward financial statements. Fifty-three percent of the individual stockholders do not believe that the annual report can be written so as to be understandable to the average stockholder.

So, Mr. Chairman, this one user group itself is dismayed. Fifty-eight percent of the shareholders did not consider the annual report important when they make a decision to buy or sell stock.

Finally, the average shareholder spends approximately fifteen minutes reading an annual report. This is according to their study.

Can a financial report be made understandable to anyone who will only spend fifteen minutes reading it? We think not.

Why is the average shareholder frustrated with the annual report to the point that he is willing to devote only fifteen

minutes to reading one? We believe part of the answer lies in the pace of his life, its accelerating transience and his need to spend most of his energies to cope with day-to-day occurrences.

Alvin Toffler, in his book Future Shock, says, "The acceleration of change radically alters the balance between novel and familiar situations. Rising rates of change, with a faster flow, compel us not merely to cope with that faster flow but with more and more situations to which previous personal experience does not apply."

Well, Toffler is not addressing himself to financial statements. Think about the rate of change in accounting. In one twelve-month period, August, 1970 to August, 1971, that supposedly inactive body, the Accounting Principles Board, issued five new opinions on such complex subjects as business combinations, intangible assets, equity method of accounting, accounting changes, and interest on receivables and payables. And, I might add, our Committee on Auditing Procedures is still struggling with SAP's to implement most of those.

Can any untrained user be expected to keep up with such a rate of change? We do not mean to suggest that improvements in general-purpose financial statements are impossible. To the contrary, we believe that general-purpose financial statements can be and must be improved. However, we firmly believe that improvements can be implemented only if the audience for the statements is defined to exclude the untrained user from the area of primary concern.

I might add that in connection with APB Opinion 21 which

has just been released, I think it would be very interesting if the first note in the accounting policy statement said "Beware--seek the advice of a trained counsellor."

In our written testimony we have suggested numerous improvements in general-purpose financial statements for the Study Group's consideration. Let me briefly summarize them. First, require all financial statements to be presented in comparative form. Second, include a five-year summary in all general-purpose financial statements, not just those for public consumption or filed with the Securities and Exchange Commission. Third, find a way to present forecasted information in published annual reports.

We have suggested that a starting point might be for the enterprise to submit a forecast to its independent auditors at the beginning of the fiscal year. Such controlled forecasted information could then be included in the annual report at the end of the year. I'd suggest that we are only talking about a starting point, a way to get started, of putting forecasts in annual reports.

Fourth, present information on business segments. We suggested, as a partial solution to the present controversy surrounding the definitional aspects of this problem, that consideration be given to presenting the information according to the managerial units in which the enterprise conducts its business--for example for a manufacturing enterprise, information could be presented according to the major factory locations; for a national retail operation the information might be summarized

according to the major geographical units in which the enterprise is arranged for top management purposes.

Fifth, in general, the accounting profession and management should move toward financial statements which present accounting information on the basis of fair values or price-level indexes. In answer to a question I am sure I am going to be asked, "either, or both." A good first step in this direction might be to begin presenting selected values or price-index information in supplementary statements or schedules accompanied by the label, "not auditable."

What we are suggesting here is, let's get started trying this out so that we get some empirical information on how it works.

Sixth, general-purpose financial statements could be made more useful if comparative industry statistics and ratios were included. Management should be required to provide appropriate commentary relating to the statistics and ratios. We think it would be likely that at least some of this information would be labeled "unaudited."

Seventh, in our written testimony we suggested a number of additional disclosures relating to specific accounts, such as inventories, fixed assets, allowances for doubtful accounts, and long-term debt. We also believe that general-purpose financial statements should include disclosure of certain non-financial information such as the expiration date of union contracts and the date on which such contracts can be reopened, the marketing expectations and related marketing budget for the next fiscal year and information about new products.

We recognize that a number of problems will have to be solved before the expanded information which we have suggested can be included in general-purpose financial statements. We foresee two principal problems. First, the expanded information may impose an unwarranted burden on small companies. Accordingly, various levels of required information should probably be established--for example, statements for companies with less than fifty thousand shareholders and maybe unaudited statements might omit some of the information. Second, some of the information could be detrimental, in some circumstances, to the company and its shareholders. Accordingly, standards would have to be established for the omission of such information. There is some suggestion along that line in the current literature, in paragraph 5, Chapter 9 of SAP 33.

I'd like to turn now to the second issue which we would like to discuss, and that is whether the present form of the attestation, the standard short-form report, should be revised. The present short-form report is essentially a compliance certificate. The operative language in the opinion paragraphs says, "...presents fairly in conformity with generally accepted accounting principles," and this can be interpreted as saying that if the statements conform to generally accepted accounting principles, they are presented fairly.

We believe that there is a higher standard. In analyzing the charge to the jury by the trial court in the Continental Vending case, the United States Court of Appeals said, in part, "The critical test was whether the financial statements, as a whole,

fairly presented the financial position of Continental and whether they accurately reported the operations. If they do not, the basic issue becomes whether defendant acted in good faith."

Proof of compliance with generally accepted standards was evidenced, which may be very persuasive but not necessarily conclusive that he acted in good faith and that the facts as certified were not materially false or misleading. In short, the court is saying that statements may comply with generally accepted accounting principles but may nevertheless be false and misleading. How can this be?

We believe that the key to this question is set forth in a research study to the Financial Executives Research Foundation, prepared by Robert Mautz. I am interested to see that he is on the program this afternoon; perhaps he will be able to explain his paper better than I. The study is entitled, "Effect of Circumstances on the Application of Accounting Principles." After a library study and examination of actual cases and seminar discussions with experienced people, Mr. Mautz says, "A strong conclusion emerges that there is no inherent rightness in any given accounting method, apart from the circumstances in which it is to be applied."

If we examine other life situations, Mautz' conclusion should not be a surprise. For example, a federal government anti-poverty program may be excellent conceptually but disastrous in the application. Advice on child-rearing may be sound conceptually and effective in the application to most children, but for one child in a thousand the advice may prove to be a disaster. I might say, that must be my child.

In summary, we believe that accounting principles are only as right as the way in which they are applied and the result which they produce in each situation.

Do we suggest that there should be no rule and that the transactions which are substantially the same should not be treated in substantially the same manner? We do not suggest this at all. We suggest instead that if we set as our goal the fair reflection of transactions and events, then like transactions and events will be reported alike. At the same time--and we think more importantly--different transactions and events will be reported differently. Things should look different in financial statements if they are different. Comparability is a concept we hear frequently discussed in this context. Accounting Principles Board Statement No. 4 defines "comparability" as follows. "Comparability means the ability to bring together for the purpose of noting points of likeness and difference. Comparability of financial information generally depends on like events being accounted for in the same manner."

We agree wholeheartedly with this definition. Comparability does not require absolute uniformity but it likewise does not permit unrestrained flexibility. On the other hand, we deplore the tendency of some accountants to equate uniformity with fair presentation. Detailed accounting rules mandatorily applied, may lead to conformity. But, given the complexity of life, they will frequently lead also to lack of fair presentation.

In an exchange of correspondence in the February 1972 Journal of Accountancy on the subject of the opinion paragraph's "...presents fairly" language, Douglas Carmichael of the Institute

Staff makes the following comment:

The committee on auditing procedure has for some time had the question of short-form report revision on its agenda. One of the proposed revisions is to change the phrase in question to read "presents in all material respects...in conformity with GAAP."

Now, you all understand that what's happening, here, is that the word "fairly" is omitted, and it just says, "presents, in all material respects." Mr. Carmichael goes on:

In my view, this change coupled with the position in APB Statement No. 4 that the introductory phrase should never be separated from "conformity with GAAP" would go a long way toward achieving communication with report users.

In short, what Mr. Carmichael is suggesting and what many people have suggested is that the words "presents fairly" should never be read except in conjunction with "generally accepted accounting principles."

We disagree with this. We view the elimination of the word "fairly" and substitution of the phrase "in all material respects" as a step backwards. Such an approach will be even more in the direction of a compliance opinion than the present standard short-form report. The profession must recognize that it cannot hide behind "conforms to generally accepted accounting

principles" when we know a client's financial statements are misleading or even false. This is the clear teaching of the Continental Vending case.

Moreover, we believe that more is expected of us as professionals than simply compliance with a rulebook. On the other hand, we know that if auditors' reports were presented without reference to a framework of standards and rules, the result would be chaos. Absent standards and rules, many companies would argue for accounting practices which have long since been rejected as not leading to fair presentation. Moreover, the accounting profession would have to fight all over again many of the dramatic battles it has won in recent years.

For these reasons, we suggest a new short-form report which adopts a middle ground and meets two criteria. First, we should have a short-form report which encourages continued improvement of accounting standards. Second, we should have a short-form report which enables the accounting profession to deal with the fast-changing life and business conditions of the future. Such a report will need to encompass both fairness in presentation and compliance with the profession's standards.

We suggest an auditors report along the following lines, "In our opinion, the financial statements of XYZ Industries, Inc. (which do not necessarily reflect economic values) (and we'd be happy to strike that language, if the time ever arrives) "in all material respects:

- (a) fairly reflect (underlined) transactions
and events;

(b) are based on the application of accounting and reporting standards which conform to published standards of the American Institute of Certified Public Accountants...

(I guess we will have to say "Financial Accounting Standards Board," next week.)

CHAIRMAN TRUEBLOOD: Thank you!

MR. WERNER: ...and

(c) properly disclose the accounting standards applied and any changes therein from the prior year."

This approach contemplates that there be a separate statement on scope of audit, and it does integrate with the Accounting Principles Board Opinion on disclosure of accounting policies. We know that many of our professional colleagues will object to this approach on the ground that an opinion on financial statements can be rendered only in the framework of specific standards and rules. In response to this objection we pose the following questions. How specific are the present standards and rules of the profession? Second, given the complexity of life, how much more specific can we make the standards and rules without becoming arbitrary and capricious? Third, isn't the concept of fairness in presentation as clear to the professional accountant as honesty and decency are to the public? Fourth, short of federal legislation, how can we avoid responsibility for fairness

of presentation in addition to compliance with generally accepted accounting principles, and, more importantly, should we avoid such responsibility?

In summary, we make two recommendations to the Study Group today. First, the trained user should be the primary focus of general-purpose financial statements. Second, we should have a new short-form report which relates not only to compliance with rules but also to fairness of presentation. The accounting profession is now at the beginning of a new era. We are confident that historians will view the work of the Study Group as a landmark. We are pleased to assist you.

CHAIRMAN TRUEBLOOD: Thank you, Chuck, very much. Interestingly enough, in one of our group meetings with one of the exchanges--I believe it was AMEX--they classified investors into three categories: the professional, sophisticated investor--I think that would include the analysts; the second group would be that body of people, such as the trained business person, who should understand financial statements and, thirdly, all others.

Now, I presume your presentation would be consistent with that; your use of the term "untrained" would be consistent with this third category of "all others," is that right?

MR. WERNER: That's correct, and I think that's helpful--that includes my wife and my daughter and all those people.

CHAIRMAN TRUEBLOOD: And the casual investor?

MR. WERNER: Yes, that's correct.

CHAIRMAN TRUEBLOOD: Carrying that further, then, the general-purpose financial statement that you would contemplate

for that group would be significantly simplified? Is that the thrust?

MR. WERNER: No, that's incorrect.

CHAIRMAN TRUEBLOOD: That is incorrect?

MR. WERNER: No, I think, if we started trying to simplify what essentially is not simple--namely, business life--you are going to end up with some very distorted numbers. Look what happens to everything when we simplify earnings per share. Let's say we simplify it to five figures. Then those five figures will will become the focus. I suggest we not do this. I think things should not be boiled down to be simple when they are not simple.

CHAIRMAN TRUEBLOOD: Then your position is that we can do nothing for the untrained investor, and we should not try?

MR. WERNER: That's exactly correct, other than to perhaps warn him that in using these statements he needs the advice of someone capable of analyzing them.

CHAIRMAN TRUEBLOOD: So, there are some overriding caveats, as you have indicated in the case of APB Opinion 21, "Don't read this or try to understand it--go to somebody and have them tell you what to do"?

MR. WERNER: That's right. Don't seek medical advice from your wife or out of the handbook. Seek it from somebody who knows.

CHAIRMAN TRUEBLOOD: A problem Dr. Spock found himself in, too! Don?

DEAN EDWARDS: Do you think the reporting standards you have recommended can be accomplished within the framework of the

current financial reporting process?

MR. WERNER: Yes, I believe they can.

DEAN EDWARDS: That is, do you see a need for additional financial statements?

MR. WERNER: I am sorry, I didn't understand your question correctly. Yes, we believe that there should be various additional statements. I might digress and say to you that I hope that all this additional information won't take the traditional form. Every time the profession has suggested additional information, that information has gone into a footnote. We hope that there will be arrays, for example, schedules, sophisticated analyses, bar graphs, charts, what-have-you.

Yes, we contemplate that the package would include a variety of additional schedules and information.

CHAIRMAN TRUEBLOOD: But, by the very form and nature and presentation, then, you might be getting some knowledge into that large, untrained group that they cannot presently extract-- or, do you choose not to be concerned about that?

MR. WERNER: Let's get the position precisely accurate-- we said, they should not be the primary concern.

CHAIRMAN TRUEBLOOD: Primary?

MR. WERNER: I think, if we can help them a little that's fine, but I hope we don't get bollixed up and prevent real progress by being overly concerned about it.

MR. GELLEIN: Chuck, as to both forecasts and fair-value statements, it's your position that the auditor should not attest to them. Is that because he is not competent to do so or because

of legal problems, or both?

MR. WERNER: Well, I have a legal background, and a legal implication is strongly in my personal thinking. However, many of my partners feel that is important, also.

MR. GELLEIN: Well, if that is the reason--the legal implications--doesn't the management have the same legal problem?

MR. WERNER: Yes, I suppose they do, but I am positive that they have more information than I do as an auditor.

Let me say one other thing. Let's clarify this situation in the United Kingdom, with the United Kingdom forecasting. In the United Kingdom I think the position is quite succinctly put in the code to the effect that the accountant is not qualified on commercial transactions (and the commercial-transactions part of the forecast includes the assumptions). Their standard audit attestation that they give in connection with the takeover bid, which is where they usually give these things, is that the forecast was footed from the assumptions. I am not sure I understand "English" English, but I think that means, "derived from the assumptions," so they essentially don't give an opinion on the assumptions themselves.

CHAIRMAN TRUEBLOOD: Extending Oscar's question a little bit, on the supplemental data, what was your phrase--that some tabulations might be headed "non-auditable" or "not audited"?

MR. WERNER: Sure, I think that's a good way to start. Let's have some experimentation.

CHAIRMAN TRUEBLOOD: Does that really mean you can't audit them? Let's say it's selling floor space in a retail outfit,

something like that; does it really mean that they are not auditable, or that they are not auditable in the sense of the precision one normally expects from an auditor? Maybe my example isn't very good--but, is my point clear?

MR. WERNER: Yes, the point is very clear. Well, I think precision is a part of what I am saying. What I am really saying is, I don't think we really have the information, the facts, the knowledge, at this point, to make these things auditable. So I am giving a much broader answer than what you are thinking about. I must say that I think it depends upon the expertise of the auditor in a given field. Your firm, for example, has great expertise on a specific subject you have mentioned; ours might not, and might have it in some other fields, so I think that has a bearing on it.

It seems quite clear to me that fair-value accounting or even price-index accounting, thinking about going down, for example, to an index on real estate for a given country, that kind of material really isn't auditable right now and I think it's correct to say "not auditable." Now maybe five years, ten years, twenty years from now that information will be auditable because it will be based upon things that are sound, that we can look at and can audit and that have some credibility to them.

CHAIRMAN TRUEBLOOD: But, playing the devil's advocate, let us say any one of our firms represented in the room is dealing with a complicated work-in-progress inventory in, let's say, the electronics industry. It seems to me, your analogy makes the inventory determination nonauditable, in such circumstances,

because we aren't engineers; we do not understand electronics.

MR. WERNER: Well, with your indulgence, Mr. Chairman, let me give you a sixty-second anecdote on the subject. A young accountant at our firm was taken to our Chicago office to do a very sophisticated audit on an electronics manufacturer located in Grand Rapids, Michigan, making something called "blip scopes" for submarines. And, quite frankly, looking at these as an auditor he couldn't even tell what the things were, much less whether they were obsolete or valued properly, and so forth.

Now, I think we can do some things in connection with that kind of an item. I think we can look at the accounting records and see that costs were accumulated on it. I think it does present some significant difficulties for us. In this particular case I encouraged the account administrator on that particular engagement to hire an engineer to assist us, and he did so. So I think we should not feel that we have all the answers. We should bring in others.

CHAIRMAN TRUEBLOOD: Frank, first, and then Sid.

MR. WESTON: In terms of the objectives of financial accounting, you have basically set up a two-part attestation formula on page 11. One, "fairness" and the other, "whatever standard might be established." But in trying to establish an objective "fairness," I suppose, is not quite operational enough. Would you believe that it should be detailed along the lines of economic status? In other words, at the bottom of page 11 your report says the statement "fairly reflects the transactions." That really doesn't cover the point at issue. Do they, in fact,

fairly represent the economic status of the company? Is that what you have in mind, in terms of fairness of the presentation?

MR. WERNER: Well, if you will read the paper which I delivered today, that point is amplified. I know that concerns many of our colleagues about this attestation which we have been suggesting for some months now. I think initially we probably do have to put a parenthetical in the lead-in...

MR. WESTON: That disturbs me, about your reading the insert, "which do not reflect economic value," and then you turn around and say they "fairly present," which is a contradiction.

MR. WERNER: Which "do not necessarily," is what I said.

MR. WESTON: Yes, but that's a contradiction in terms, in the use of the statement, it seems to me.

MR. WERNER: In other words, something can't be "fair," in a sense other than economic. Okay, right, I understand.

MR. WESTON: The thrust of my question is, do you believe that "fairness," per se, requires an evaluation of economic circumstances, as an objective, you see?

MR. WERNER: Maybe, ultimately, yes.

MR. WESTON: Can we move quickly to the "fairness" report which you recommend, before we've done our fairness-of-principle determination?

MR. WERNER: Yes, I think we can. I think we can write an SAP, for example, defining what we mean by those words and that kind of a breakdown in the opinion paragraph, and maybe we define it differently now than we might redefine it fifteen years from now.

MR. WESTON: So, is your firm willing to be measured by that, starting January first?

MR. WERNER: Yes sir, we would. As a matter of fact, I think, legally, we are all measured by it right now, regrettable though some may feel that is.

MR. WESTON: I don't think many people would agree with you, but I understand the point.

CHAIRMAN TRUEBLOOD: May I ask whether we could have, in advance of the transcript, a copy of the paper?

MR. WERNER: Yes, I have delivered a hundred copies, today.

CHAIRMAN TRUEBLOOD: That will be very good. I think we must move on, Chuck. Thank you very much. It was a very useful paper, indeed. And we will hear next from the National Association of Accountants. Mr. Kelley, are you ready? It's all yours.

MR. E. W. KELLEY (National Association of Accountants): Thank you, Mr. Trueblood. My name is Ed Kelley. I appreciate your Committee giving the National Association of Accountants an opportunity to express their views here today. I represent the MAC Committee--that's the "Management Accounting Committee" of NAA, and normally our Chairman, Wayne Keller, whom many of you know, would be here. I am subbing in his place. The MAC Committee is composed of ten members, two of whom are educators, two of whom are CPAs --they happen to be partners of the Big Eight-- and six executives from industry, some of whom are chief financial officers, and others, such as myself, who are in other fields

presently. We represent the 65,000 members in our organization. We have 275 domestic chapters and 11 international chapters.

You have in front of you, I believe, and hopefully have read the short report we have prepared. Even though this report is quite short, it represents many hours and days of discussion of this general subject by the Committee and some subcommittees that worked with it. I might say that all decisions and pronouncements of our Committee require a positive vote of eight of the ten members on each point. So, what we have given you here are a few key things we feel are important to the subject we are discussing today.

I suffer slightly from not having heard the prior comments because I came in as my immediate predecessor in this chair finished, but I shall be happy after briefly commenting on this paper to answer any questions that you may have of our Committee as to why it feels the way it does.

If you refer to our brief but, I feel, very important document, it makes four or five key points. I might, before going into these, comment that this document is prepared based on financial statements for external users, not internal management.

The first point which we feel is very important--and, we have details and data behind these statements we have made in this paper--is that we should deal with qualitative information as well as quantitative information. In other words, information should be given external users that aren't necessarily possible of being in the books of account. Once you have taken this

position, you have to almost immediately, we feel, accept these premises or assumptions: first, that the type of information has to vary by the nature of the business and the nature of the company; of necessity, this information has to be furnished by management; it has to be backed by management--it is not necessarily certified, probably not, and is not even within the judgment power of the certified public accountant; second, that the main purpose of this qualitative information is to reflect and tell the external user--and this external user is all categories of user, from the innocent little non-sophisticated analyst, such as myself, but who might not want outside advice from one of the large Wall Street firms, to the very sophisticated young college graduate working for the Wall Street firm--it should reflect the current status of the business and the progress that is expected for the business to be taking in normal events.

The second point we make in our paper is that we are dealing with one audience of outside people and whatever we give we should give to all. This audience is investors, both potential and actual, as well as creditors and various other users of statements, and I suppose one has to include those people interested just from a public policy point of view. This information should deal with all the material available to the public, in general, or, let's say the important parts of it. Obviously one can't include in these reports everything, and what might be important for one company would not be for another.

The third point we made--and, I am not necessarily covering these in the order they are in the paper or necessarily

in order of importance to our group--is that forward estimates are highly desirable. It took at least a half day of debate and many points of view for us to resolve how we felt on this point, and we ended up by having a unanimity of opinion. We say "highly desired," not "required," for a very valid reason, in that there are some of us who believe there are a few situations where this sort of thing could be misleading and could be derogatory to our overall objective rather than helpful. It got into very complicated positioning in some situations. However, we feel that management--be it of a small company or large, be it of a public company or a semipublic or family business dealing with, let's say, just creditors--has a responsibility, certainly to themselves and to others, to think in terms of the status of the business, where it's going, why it's going, and there to give it a general position on this. However, if these forward estimates are given, it's necessary that they deal with the critical factors of the business. The reason I say that they have to, varies: the critical factors for one business may be very much different from the critical factors of another business. For example, in the cigar business, you'd be interested in share of market. Share of market might not be important for a government defense contract or some little complicated technical manufactured item.

The assumptions have to be stated for the information to be meaningful because if I were to give you a projection without the assumptions, it would not be very meaningful. As I said before, we do not feel it can be certified because it puts the public accountant in the shoes of judgment, and if my public

accountant knows as much about my business as I do, he should be running it. We're afraid if it were 100% required it could hurt credibility, because of the results that would happen in some cases.

Turning to the next point, we feel accounting has a future responsibility: certainly it isn't prepared, today, to deal with the value of human resources and the other unrecorded resources that are important to a business--brand names, franchises, patents, capability and all of these things--and we say these things are very necessary to be studied and talked about, and before we start talking about them we'd better know what we are talking about.

We recognize there is an area that is badly needed in a place where the public accounting field as well as the accounting field in total can render business a great service for the future. We are concerned about rushing into price-level accounting or value accounting or this sort of thing because we feel we are not ready for it yet. We don't have the ways of handling it.

I might say that I know of one company that probably leads in value and price-level accounting, Phillips, and right now in addition to the problems they have in manufacturing and slowdown and so forth in Central Europe, they have a problem of value and price-level accounting, and this has aggravated the picture of the Phillips company. I suggest you might want to look into that if you haven't already, if you are considering this as an important subject.

The final point that we make--and this is just one

phase in our report--is that we should be very careful to deal in standard terminology when we can. By "standard terminology," we mean try as a profession to get better terminology, but at least each individual company and each industry should deal with standard terminology if possible so that what we say is more meaningful. We should not require in many instances standard terminology, because this puts into a straightjacket those things that should not be.

I haven't necessarily used up my allotted time, but I believe I have enumerated the points in our paper. I shall be happy to try to answer any questions you have.

CHAIRMAN TRUEBLOOD: Thank you very much. We will use up your allotted time, I think, in questioning you. Just as a matter of information, before we start the general questioning, the MAC work on segmented reporting and interim reporting is, in my view, excellent. I think we are going to have to consider both subjects from the standpoint of objectives. And I know that you did, in I believe four regional seminar presentations of both subjects, did you not?

MR. KELLEY: Yes.

CHAIRMAN TRUEBLOOD: Is there going to be any available output from those seminar sessions, or was that for the information only of the MAC group in refining their presentations?

MR. KELLEY: Well I do not speak officially for the Committee, but personally I would see no reason why that data couldn't be made available. I reviewed some of the questions and answers in preparing for this morning's presentation. We

were disappointed in a sense with those. Yet I told the Committee I thought we should not be disappointed. We had in, I think, one a good attendance, and in a second quite acceptable attendance, and in two of them what many thought was unacceptable attendance. However, as you know, one of the main purposes was to be sure our 65,000 members had a chance to be heard, and I told Wayne Keller I thought for that reason alone that it was worthwhile.

A lot of the comments dealt with a person's own point of view and company situation with respect to these questions. We did get several letters from some top financial officers of some very important companies and other people throughout the country that stated what they agreed with and what they disagreed with. They were very positive, even though they made the point that they made an exception to it. I would think those perhaps might be of equal importance to you. When you get letters from the chief financial officers of two of the large oil companies saying what they think in respect to these questions, two of, let's say, the top six or eight of the world, I think it's meaningful to the guy who went to the meeting.

I would suggest you take it up with our staff and see if there is any reason we should not give it.

CHAIRMAN TRUEBLOOD: The results have been transcribed?

MR. KELLEY: We have a transcript of those meetings, yes.

CHAIRMAN TRUEBLOOD: So, we should be in touch with...

MR. KELLEY: ...with Jack Gibson, who is at the back of the room here.

CHAIRMAN TRUEBLOOD: Well, I think they would be very

helpful to us, if they are available.

MR. KELLEY: You might also be interested in a transcript of our discussions, which I think might be more meaningful to you.

CHAIRMAN TRUEBLOOD: Maybe even more meaningful--we could use those. I am really quite fascinated, personally, with your first point, which is covered by the sentence on page 5, "A financial statement which does not contain qualitative information, and quantitative information from sources other than the accounts, will not meet the objectives stated in the first paragraph."

Did you or did you not take the position that there should be a standardization of such qualitative information, for example, by industry?

MR. KELLEY: We suggest there be no standardization.

CHAIRMAN TRUEBLOOD: There should be no standardization by industry?

MR. KELLEY: Yes. I would personally say this. I said this at the Committee meeting. I think there could be a checklist or some sort of thing, where management should be required to take a position that this isn't pertinent or is not meaningful. I would go that far. I don't think some of our Committee members would go that far. Then this would assure you of, let's say, getting more quality at the point of quantity.

CHAIRMAN TRUEBLOOD: But, you would make the presentation of such information...

MR. KELLEY: If you want to spend two more hours with me

some day, I can take the businesses I am responsible for and explain to you point by point where a requirement of certain standardized information is either too generalized to be meaningful or is in conflict and not right for that business. I assume you aren't going to try to put tons of information into these reports.

CHAIRMAN TRUEBLOOD: But what might be specific of Macy's and Gimbels, for example, you would think might run in parallel, but, as between Sears and Federated, for example, there might be a significant difference in the qualitative information?

MR. KELLEY: Well without being considered argumentative, I have only spent five years in this industry and I don't feel qualified to answer your question. Now, I am responsible for a cigar business, a lighter business, a food business and a cosmetics business, and I can tell you that even though those sound closely related I would deal with them I assume differently.

CHAIRMAN TRUEBLOOD: I can well understand that, and you used much better examples than I. Okay, Sid?

DEAN DAVIDSON: I know you weren't here for the earlier presentations, but when we were talking with the financial analysts about 5.5 of their presentation, they say that the concept of measuring social costs or a report on those costs "would be quite outside the scope of accounting and financial statements."

I take it that your last paragraph on the other disclosures would suggest that you feel that reports on social costs are in fact not only not outside the scope of accounting and financial statements but, as you say, are essential if financial statements are to meet their objectives.

MR. KELLEY: Do you want a "yes-or-no" answer?

DEAN DAVIDSON: Yes.

MR. KELLEY: I have to answer "Yes." However, I need to qualify that and say that no one, to my knowledge, is prepared today to deal with this adequately. As the world is changing, these values are becoming of greater importance. I think that can't be disputed. There are certain industries where this is more important than others, certain companies. You have some companies that are quite important in today's world that deal quite a lot in this field of value, and we as a profession--now I am putting on my CPA hat--as accountants and CPAs, and so forth, have to find a way to deal with this as the world changes. If you are talking about financial statements for external uses, to me this is what you are going to give the outside world to judge your business, and I am not talking of what is certified and what is not certified. I am talking about how you are going to judge the business.

DEAN DAVIDSON: Could you give some examples of the form that such a report on social cost would take?

MR. KELLEY: If we had known the form, we wouldn't have said it would have to be studied. All we say is that this is something that all of us better get at. Let's not wait until we have a problem; let's anticipate the needs and the problems of the financial world. That's one reason we have the problem we have here today, if I may be slightly critical.

CHAIRMAN TRUEBLOOD: Well, I think you are very right. The intensive work, even of your MAC Committee, as distinct from

our two groups, is evidence of that external demand. Do you agree?

MR. KELLEY: Yes. And it's not just human resources. It deals with other things. Some of the most important companies in this business world have some of their greatest values unrecorded in the books.

CHAIRMAN TRUEBLOOD: I see.

MR. KELLEY: Not just human resources, but other things. If I may laugh with you one second, that's one reason the conglomerate movement got started.

CHAIRMAN TRUEBLOOD: Anybody else on the group ready with something?

MR. WAGNER: I'd like to ask Mr. Kelley whether he or the group have given any conceptual thought to more specific definition of the publication of forward estimates of the material aspects of the business and exactly what is implied in this.

MR. KELLEY: No. We spent more than one meeting arguing policy, you might say, and we had one or two members who wanted to go further than we did here. We had one or two members who felt this was, say, going too far with a policy statement, and we argued it out without, I believe, representing the point of view of our companies who are associated with that. Most of our people are independent, you might say, financially and jobwise, of the companies they are associated with, and I think that should be important to you. This is on our agenda, as to how to deal with it.

I have some personal ideas, but I don't think it would

be fair to the Committee to sit up here and enumerate them.

MR. GELLEIN: Could I ask one? You have a sentence saying that a major objective should be that of avoiding surprises in the investing community. I assume you mean both pleasant ones and unpleasant ones?

MR. KELLEY: For sure! I admire the set of annual reports and statements that can talk about the bad as well as the good things.

MR. WESTON: You have some general words in pages 5 and 6, describing the form and content of the main financial statements reflecting the "status" of the company and comparison of actual to relative "financial standing." We have had some discussion and much presentation before the group on the use of more current values. Would you care to give us your views as to whether those words imply use of more current values than historical costs?

MR. KELLEY: I think they imply studying the subject of current values. I know of no one today who's been able to deal with it adequately. To the best of my knowledge, the Phillips Company in Europe, as I have mentioned, I believe has done the most in this field. I think one of the reasons for some of their problems now is because they may not have done it correctly. This is heresay, but it's hearsay in the business community in Europe. We are going much broader than that, however, because we believe there are many valuable conditions--and, I use the word "condition" to get away from a word such as "assets" here--of a business that are very pertinent to its present status and to its future status.

What's going on in my research laboratory right now is maybe more important than last year's results. Now, I frankly don't know how to put that in a set of financial statements. I believe that I should comment on it in my report.

CHAIRMAN TRUEBLOOD: I have forgotten what paper it is in--all the papers were supplied to witnesses, but you may or may not have run across this one. There is a statement made in one of the papers that, for the purpose of internal decisions, it would be unconscionable not to consider a fair evaluation of all assets or conditions, but that paper goes on to say that for external purposes it would be completely inappropriate to convert general purpose financial statements to fair values.

Can you, in your experience, reconcile those points of view for me?

MR. KELLEY: Will you allow me to be able to be a bit personal? I will comment on it.

CHAIRMAN TRUEBLOOD: Yes, surely.

MR. KELLEY: You get into the problem of full-costing and contribution-costing and all these sorts of things in internal management, and I am a firm believer that you should know as much about the situation as you can when making a decision internally. The problem you are dealing externally with is that no one knows all the innuendoes, all the little backgrounds, all the qualitative things that get you to use a certain set of figures. It becomes impossible. Just like I sit here and tell you something today and the ten men around you will interpret it slightly differently perhaps than you do. It's become a problem of communications,

I guess.

So when you go from dealing with all the things that your inside group can understand and do and work together after months and years of teamwork, to say something that could be taken completely out of context, but at least could be misunderstood, you have problems. And the minute you put it outside, you have to be sure that more people are going to understand it correctly than will understand it incorrectly. Otherwise you are not going to be doing the external user any service.

CHAIRMAN TRUEBLOOD: So, what you are really suggesting, as an individual, is that there is less risk in using these alternate evaluations internally, because, internally, you understand them?

MR. KELLEY: You have all stances, all the background, all the interrelationship, and so forth.

CHAIRMAN TRUEBLOOD: Whereas, it would be impossible or impractical to make all of that available?

MR. KELLEY: Look at what happens to a per-share-earnings figure. You know, you narrow it down to one figure and deal with that figure, as if it were God's...

CHAIRMAN TRUEBLOOD: The trouble is, we have narrowed it down to sixty.

MR. KELLEY: What I am suggesting, personally, is I think there are a few areas where you can deal with these things, where the advantages are more than the disadvantages. But let's walk before we run, and let's take those things where there is a better chance of a good understanding first. They may not be the

most valuable, may not be the ones you'd want in the long range, but let's not be proud of something that confuses rather than helps.

CHAIRMAN TRUEBLOOD: A very sound approach, I am sure. I think it's typical of the care that your MAP group has given many very difficult subjects.

MR. PARKER: On page 6 of your statement, it is mentioned that the figures ought to be stated for a given company on a consistent basis, to permit users to determine relative financial standing. Other of your comments have indicated that you feel there ought not to be too many restrictions put on what kind of accounting policies are used.

Could you expand a little bit on what other kinds of things you think can be done to improve understanding of relative financial standing of the company? I presume that means comparing with other companies.

MR. KELLEY: Or, with your own, primarily. "Relative" can be "to yourself." I think the external user is probably more interested in what's going to happen to my business tomorrow than what happened yesterday. He is interested in yesterday as a background to that. Let me talk about businesses I am familiar with.

I would say that included in this should be share of market of consumer products, trends of those, the effect of new products on the present products, labor conditions, and worldwide competitive conditions, although this can't always be forecast. We import almost all of our tobacco for cigars, and when Nixon decided to do what he did last August it made a whole new ball game out of it and I couldn't have forecasted that.

Now we have recovered rather quickly, so it became only a three-month problem. I would include that sort of thing, in our businesses, what you are doing, and about new products. These have to be qualitative things, but I can, say, enumerate the top ten food companies of the country and I could tell you, almost by my own judgment, what the product research and development situation is, in each. To me, that's just as important as the cash they have in the balance sheet.

I would think a company should find a way of talking to that point in its reports, to the outside financial users. First, what happens is, the companies doing well have better statements than the ones that aren't. Let's see if I can think of some other things.

MR. PARKER: I guess I was really hoping to lead you to make a comment on the sometimes emotional uniformity-versus-flexibility issue.

MR. KELLEY: I feel--and again I am speaking personally now--that those things that we are talking about are qualitative and should stand the test of reasonableness. But beyond that, you can't go, because anyone has to know more about it than management does to go further than that. I like to deal with the critical issues of business, you might say, whatever they may be, as those qualitative things that management should address itself to, which really is what a man like myself tries to do when you go up before the securities analysts.

Now, I wasn't purposely trying to evade your question. Would you want to ask me again, if I haven't answered?

MR. PARKER: I thought the question was posed toward the types of accounting policies used, and more on the quantitative side than the qualitative side. You have made some reference to leaving a fair amount of flexibility for management to report. On the other hand, you have made some reference for a desire and need for users to be able to compare companies, one with another.

Do you have anything to amplify that, or bring the two together?

MR. KELLEY: As a Committee, we feel entirely different about comparisons among companies than we do about monitoring a track record and future outlook for an existing company.

MR. PARKER: You feel this would be so for the investor as well?

MR. KELLEY: It's very desirable from an investor's point of view to try to compare one company to another, as much as he can. This can be a trap for him, however. This presumes, if you want to do it well, that all companies are run the same. They are not. It presumes that even a few companies deal with the same sorts of problems. They do not. The coffee business is entirely different than the frozen food business, and you'd better realize that in your annual listing of the financial statement.

CHAIRMAN TRUEBLOOD: Mr. Kelley, I am playing the devil's advocate, here; I do this for the purpose of clarification, not in any way for the purpose of embarrassment. Maybe there is an explanation for it which I haven't dug out. On page 6, you say, "Where pertinent, financial statements should be accompanied by data relative to such items as market position, order backlogs,

and revenues, by classes of customers." Then I read the diversified-companies discussion outline that was used in the seminars we talked about briefly, and that says, "Disclosure of sales order backlogs should not be required, either for segments or for the whole company."

Now, on its face, this would seem to be an inconsistency.

MR. KELLEY: It's a fundamental issue. Underline the word "required."

CHAIRMAN TRUEBLOOD: "Required," I see. That is the distinction you would make?

MR. KELLEY: And you are aware that "pertinent" may be, also, another distinction, where "pertinent" assumes that it's quite important and a critical factor of the business. We are saying, there, it doesn't have to be required; it should not be required. However, keep this in mind--that we are more mature in this statement we have in front of you today than months ago when we were still arguing about some of the things.

CHAIRMAN TRUEBLOOD: The rest of your sentence, in the present report...

MR. KELLEY: We are saying that if management feels that this is pertinent and is a critical issue with the business they should be encouraged to give it. Now how are you as an auditor, or myself as an outside investor, going to tell management something is "critical" or is "pertinent" if they say it's not?

CHAIRMAN TRUEBLOOD: But you would still put the decision on management, as distinguished from Reed Parker's inferences?

MR. KELLEY: Yes.

CHAIRMAN TRUEBLOOD: Very good.

MR. KELLEY: Are you finished with me, sir?

CHAIRMAN TRUEBLOOD: Yes, I am finished with you.

unless you have some concluding statement

(No response)

CHAIRMAN TRUEBLOOD: Thank you very much.

MR. KELLEY: Thank you very much.

(Whereupon at five minutes past twelve o'clock
the meeting was adjourned for luncheon.)

MONDAY AFTERNOON SESSION

May 15, 1972

The meeting reconvened at thirty-four minutes past one o'clock, Chairman Trueblood presiding.

CHAIRMAN TRUEBLOOD: I want to again remind you of the procedure. We ask you to write out your questions and submit them to our staff people who are with us. And, lest there be any confusion, I will ask them, please, to rise again, to identify themselves, so you can find them when you need them--first, my assistant, Mrs. Beattie, over there in the right-hand corner; then Marty Gans, standing there; Mike Shannon, in the back of the room; Bob Streit, over here; and Paul Rosenfield, from the Institute, up here. If you can't find one of them, bring the question up here and we will find a way to handle that, too.

Okay, Mr. Honig, I think it might be helpful if you started out by identifying your group and explaining it to the people.

MR. VICTOR HONIG (Accountants for the Public): I am here as the Co-Executive Director of Accountants for the Public. Accountants for the Public is a nonprofit corporation organized in San Francisco by a group of certified public accountants, educators and accountants who felt that there is another function for accountants, in addition to that of presenting, preparing and certifying financial statements for the business community. I will go into that as I

progress, but I did want to say a few things.

First of all, I wanted to thank Marty Gans and Paul Rosenfield for their help in getting me on the agenda and for their help in cutting down your lunch hour so that I could speak. This morning I heard the representative of J. K. Lasser say that accountants--the American Institute and members of the American Institute--do nothing with the untrained investor's group and should not even try. I think that this is where Accountants for the Public differs with the representative of J. K. Lasser.

When he said that, I remembered my having begun in accounting here in New York working for a regional firm. I progressed to the point where I was already writing comments on reports. In those days we weren't that concerned about short-form certificates; we dealt with long-form reports and extensive comments were an integral and important part of each annual report for every one of our clients. And I had difficulty in writing, and the partner with whom I dealt was quite critical of the way in which I wrote, and I said, "How can I improve?"

He said to me, "Tell you what you do. You write your comments and take them home and read them to your mother. If she doesn't understand them, you haven't done a good job."

Well, the first time around, after reading some of the comments, my mother said to me, "What's a 'reserve for bad debts'?"

So I explained to her as best I could. Next time around she said to me, "What's a 'reserve for depreciation'?"

And I explained that to her. And, as I was doing this, I began to realize that part of the function of the certified public accountant and the certified public accountant firm is that of being an interpreter.

After a while I went to the service and came back and decided to go into practice for myself here in New York, and I was asked by some representatives of the students of Columbia University if I would help in interpreting to them the report on the dormitories and on the mess hall because there was a request for an increase in fees. And we had difficulty in obtaining the financial reports from the University but finally did and, as a result of the information that was given to these students, the University agreed that an increase was not necessary. In this case I was not an advocate, but simply an interpreter of financial reports.

Another thing that I felt, today, was that the responsibilities of the certified public accountant do not end with the issuance of financial reports, as we all know. And, similarly, something which has not been stated is that the responsibility of management does not end with the payment of its fee to the certified public accountant firm, so that when a certified public accountant firm has been identified with a financial report of a particular company and has been so identified for many years, management does have a responsibility to the certified public accountant firm not to make statements which might be attributed to the certified public accountant

firm without first clearing them. This is in line with the statement concerning projections and whether or not the certified public accountant firm does have a responsibility for projections.

Now I assume because of the lateness of the time at which I did present my paper, it hasn't been available for you, so I will take the liberty of reading it to you.

With change taking place in the social structure all around us, some members of our profession have begun to feel uncomfortable with their role. This discomfort stems from the recognition that, while our basic role is not changed, the failure to participate in change has resulted in the loss of our traditional independence. In response to the growing criticism of the certified public accountant from within the profession and outside, we have begun to question ourselves, mainly in the areas dealing with the technical aspects of our work.

During the past twelve months only four articles appeared in The Journal of Accountancy which dealt with or alluded to the accountant's role in social change. Two dealt with minority employment and education, one with independence, and only one with our social responsibilities. At this point we are studying the objectives of accounting, and I propose that no study of this kind can or should ignore the changing society in which we now live and that we do emphasize social objectives.

First of all, I'd like to say that we must study the

word "public" in "certified public accountant." For too long now we have restricted our definition of "the public" to "the business public," the management and investors, banks, government agencies such as the Securities Exchange Commission, which deal with business. And as a result of such a restricted definition, financial reports have evolved which are almost incomprehensible to the otherwise nonbusiness public as well as much of the business public. No wonder there is a question about our independence and our image.

Last week I met in Washington with an economist of the Treasury Department, a former attorney of the Treasury Department and a financial journalist. We were reviewing the annual reports of several of the largest corporations of the country, prepared by the largest certified public accounting firms. None of us could state that we completely understood all of the terminology in the financial statements or of the notes to financial statements, especially to those dealing with taxes paid and deferred taxes. As the case was, I was consulting with some people about tax reform. There is a group in Washington trying to give information about tax reform. They stated that not one representative of a certified public accounting firm had been willing to participate with them in this, and I was surprised and, I think, shocked by it.

L. William Seidman has recognized the need for a consideration of our public in the article, "The End of the Great Green Eyeshade," in The Journal of Accountancy, January

1972. He said, "The CPA now has a vast public. It includes investors, managements, unions, consumers and governments and all who rely in one way or another on financial statements. Almost all of our citizens are directly or indirectly involved with the CPA's product."

When we begin to recognize the vast audience for financial reports, then we must see that one of the primary objectives of the certified public accountant is to make his reports understandable to that public, in both content and form. At first blush, this sounds like a simple task, and I thought this was so until I heard some of the testimony this morning.

Let us consider the public to whom we provide services. Traditionally, certified public accountants have been retained by business, individuals, partnerships and corporate clients, government and private agencies, to provide either audits, tax or management advisory services. Almost all of our concentration has been to educate ourselves in becoming more proficient in these areas, to attract more clients and to develop the staff which will permit us to provide services to our growing practices. And we perform these services for fees.

Of course, most of us do provide services to worthy organizations without fee, or at reduced fees, and one of our more fortunate brethren does participate in the public-service function, in the presentation of the Motion Picture Academy Awards.

CHAIRMAN TRUEBLOOD: Mr. Honig, I wonder if I might ask you to summarize, from here on in, in order to give us some time for questioning.

MR. HONIG: I will try to explain the accountants group. A group of accountants in San Francisco has responded by organizing "Accounting for the Public," which is a non-profit corporation whose objective is to provide consulting services to public interest groups by analyzing and interpreting data in areas of public concern. The group operates without fee and in a non-advocate capacity for community and consumer groups, as well as public interest law firms. We will attempt to provide analyses and interpretations of financial data in a way which will enable such groups to act in a well informed fashion in areas of broad public interest and concern. We also seek to convince students that the accounting profession is a unique and relatively untapped vehicle for those with social awareness.

We have received a modest, one-year grant from the Stern Fund located in New York. Although officially in operation for less than one month, the response has been great. Already, we are involved in matters concerning analysis and interpretation of the budget and financial statements of the City and County of San Francisco, the budget and financial report for the San Francisco Unified School District and the much debated financial agreement between the city and the redevelopment agency, and in matters concerning the public utilities commission.

Without publicity, the word has spread even outside the San Francisco Bay Area, and the requests for service are many. We have met with consumer groups. What they want is information and interpretation, and it's amazing how their requests in many ways parallel those of the Financial Analysts Federation.

Now we have dealt with business reports, and yet one of the things of which I have become aware is the fact that, in many municipalities, under the term "public service enterprises," they are really in business, and how important it is to understand what these terms mean, because the terms, in municipal reports, in business, are quite different from business reports. So we deal with "unappropriated balances," rather than "surplus," and things like that.

Now I'd like to summarize by saying that since the testimony today makes it clear that financial reports are not understandable to the untrained reader, it becomes increasingly mandatory for us to become interpreters of financial reports and to be available to those untrained groups who desire and need information contained in such statements. I want to urge the American Institute of Certified Public Accountants to take the lead in sponsoring and supporting public interest accounting firms, such as Accountants for the Public. Additionally, I recommend that it urge all the state societies and member firms to participate in establishing such public interest groups. It is in this direction that we can begin to restore our credibility, finally putting to rest the image

of the "Great Green Eyeshade."

The testimony today makes it crystal clear that the need is now.

CHAIRMAN TRUEBLOOD: Thank you very much. In your paper, you make an analogy to similar groups among the law. Is that effort, so far as you know, sponsored by the American Bar Association, or is it individually concerned lawyers who make those services available?

MR. HONIG: I think it is both.

CHAIRMAN TRUEBLOOD: It is both?

MR. HONIG: The Bar Association, at least in San Francisco, has been actively participating in the public interest.

CHAIRMAN TRUEBLOOD: And, the second question: To the extent you have been working with these municipalities, particularly in the California area--is that on a fee arrangement of any kind, on the basis of ability to pay, or is it strictly public service in the true sense of the word?

MR. HONIG: This is strictly public service. We take no fee. And as I said, we have received a modest grant which helps us work. All of the accountants participating are doing it on a voluntary basis.

MR. GELLEIN: Mr. Honig, you stated that you need to be interpreters. Is it your view that the written word, our reports and the like, are inadequate in themselves and it therefore takes the oral analysis to tell the whole story?

MR. HONIG: Well, I think that, as interpreters, it

is both the written and the oral word. I think that we have come to a point--and I think most of us have recognized it this morning--that one financial statement cannot do all things. Therefore, if our reports and our financial statements are directed toward one group--that is, the trained reader of financial reports--as certified public accountants, we have another responsibility, and this is to become interpreters of those reports to the untrained group, who also may want and need information contained in those reports.

MR. GELLEIN: You mean more than the untrained investor--you mean the untrained investor as well as other untrained users?

MR. HONIG: Can I give you...

MR. GELLEIN: I was going to ask why the analysts wouldn't do the job for the untrained investor.

MR. HONIG: May I give you several examples of the work in which we are involved. San Francisco City and County operate a railroad and it is called the "Municipal Railroad." It's really our public transportation system, and there was a move to cut back services.

A group of people from all the neighborhoods affected by this came to us and asked us if we would interpret to them the financial reports and audit the financial reports of the City and County of San Francisco's Municipal Railroad. We did, and this was the extent of our services.

As a result of this, testimony was made in an educated way at the Public Utilities Commission hearing. As a result of some further efforts, using the information that was given to them, there was a lawsuit filed and the court held that the Public Utilities Commission did not have the authority

to cut back service without the approval of the elected group of Supervisors.

MR. GELLEIN: Well, do you conclude that we could do better with the written reports than we are doing now, and, if so, how?

MR. HONIG: I referred earlier to the group I met with in Washington in reading the financial reports of one of the large steel manufacturers, and we tried to ascertain what was meant by, first of all, the footnote concerning deferred taxes, and the statement of operation showing "zero" for the provision for federal income taxes.

I think that's become a political football lately. And none of us could conclusively say what this really meant. Now we each could interpret it. But did it mean that the company paid no taxes or that the certified public accounting firm made no provision for taxes? This was not stated, in the report.

CHAIRMAN TRUEBLOOD: Well, Mr. Honig, if I may pursue that one just a little bit. This Group has met with the Treasury, and I know your point is very well made and very fairly expresses their point of view. On the other hand, it does seem to me that it may be asking a little bit too much for us, as a profession, to explain what is, indeed, a very complex world in very simple terms. The Treasury is explicitly concerned about estimating tax receipts. Frankly, for the life of me, given the intelligence that exists at the Secretariat level, given the complete detail in tax returns, and so forth,

I cannot share their lack of understanding about the deferred tax issue.

Sid, you had your hand up.

MR. HONIG: May I respond to that, please?

CHAIRMAN TRUEBLOOD: Yes.

MR. HONIG: I'd like to say that I think we are confusing things here. I did not intend to necessarily make my statement a criticism of the printed financial report. I did intend to make a statement concerning the social responsibilities and the responsibilities of the certified public accountant and of the profession to the public, and I am talking about the general public, and I feel that we are in a position to be interpreters of the written word, of the financial report.

I want to say one other thing. I examined two reports--one, of the largest banks in the country, and one, of a very small public utility. The large bank made no comment about its deferred credits, and yet the small public utility, here on the East Coast, had rather extensive explanations of how the deferred credits were used and how they were arrived at.

CHAIRMAN TRUEBLOOD: Sid Davidson has been waiting a while.

DEAN DAVIDSON: I won't make my customary speech about deferred credits...

CHAIRMAN TRUEBLOOD: I would rather you did not.

DEAN DAVIDSON: ...and how the whole problem could be solved by the repeal of APB 11. But instead, we are concerned with spelling out of the objectives of accounting--that's the purpose of this session--and I was wondering if you had any specific suggestions as to how we might couch the objectives of accounting so that accounting would be more useful in meeting this social purpose that you describe.

MR. HONIG: Well, I think we should state that the responsibility of the profession does not end with the issuance of the report, that we recognize that we do have a further responsibility, and the responsibility is to being and becoming available to those serious people who want information concerning financial reports which affect their lives, whether it be a company or a municipality, and help them understand the meaning of that report.

DEAN DAVIDSON: But, Mr. Honig, that's kind of a personal responsibility, and many of us may share your feelings that accountants and certified public accountants should assume a greater portion of that personal responsibility, but that does not relate to the question of objectives of financial statements or of the accounting process. I think those are two separate kinds of questions.

MR. HONIG: Well...

DEAN DAVIDSON: And I must confess that I speak out of some substantial sympathy for your feeling about the personal responsibilities, but I don't see how that translates into objectives.

MR. HONIG: Well, first of all, if we call ourselves "certified public accountants," we are already involved in a question of terminology. If this profession does not want to accept the meaning of "public," then it seems to me we must change the name. If we are involved in the accounting process of providing interpretations for the public--because, realistically, a financial statement is an interpretation of transactions--then we have a responsibility beyond those to whom the report is addressed. In this day a large corporation has a great impact on all of us: There is interresponsibility of the corporation with the people and with the government. Then we must begin to recognize a new era, a new function, or at least an extension of our function, and this function must be much more extensive than we have heard here today. I think this is why a group of us accountants have attempted to do something within San Francisco in this area. This is why I have urged that the American Institute accept this as one of its objectives and to sponsor such groups throughout the country. I am saying that there are public interest law firms which function only in this way, and they are supported financially, perhaps not totally, by the Bar Association, but they are given support. They are given assistance and they are getting funding from other sources.

Now our group has gotten some funding from other sources and at least the American Institute should attempt to promote this kind of thing for our profession.

CHAIRMAN TRUEBLOOD: Would it be fair, Mr. Honig, to say, in an attempt to convert your presentation to what Sid asks for by way of objective, that, apart from the mechanics of how you get to the public, that you would urge us to adopt, as an objective, the simplification or a clarification, or a simplification of our presentations? Is that a reasonable part of your plea?

MR. HONIG: I am reluctant to say "yes" or "no" to that because it's not a question which lends itself to "yes" or "no." I think we are all flirting with a particular kind of function, an idea we do have, and that is we know that in many ways our financial statements which are used by the public in any way you want to view the public are not totally clear. I think we can apply ourselves to making them more meaningful, in addition to the other aspects, either by written word or by verbal means--of a better interpretation of our financial reports.

MR. PARKER: Would you have any suggestions as to specific ways in which they could be made clear or more understandable, before you get to the point of the first interpretation that might be needed?

MR. HONIG: Well, I referred earlier to the long-form statement which we used to prepare before the short-form certificate. It seems to me that this was a wonderful way of being able to communicate with these small entrepreneurs who didn't have a financial understanding and to my mother who didn't know what a reserve for bad debt was.

DEAN EDWARDS: Sir, are you suggesting that we can take a complex subject matter like accounting, which we say is a profession, and interpret it to our constituencies? Would you make the like comparison, let's say, with professions of medicine, theology and law that we could make these understandable to the layman? I would assume, from what you have said, that this should be one of our primary objectives.

MR. HONIG: I would say so.

DEAN EDWARDS: It would be just that?

MR. HONIG: Yes.

CHAIRMAN TRUEBLOOD: Any other questions from the panel?

(No response)

CHAIRMAN TRUEBLOOD: Thank you very much, Mr. Honig. We appreciate your interest and we share your concerns about public service, and it's particularly good of you to come this very long way from California to be with us.

MR. HONIG: Glad to be here.

CHAIRMAN TRUEBLOOD: We appreciate it very much. Thank you. We have one question left over from the morning session, and I believe I saw Jack Gibson come into the room, didn't I? The question relates, Jack, to page 5 of Mr. Kelley's presentation--just one point. The statement is made, Jack, on page 5, in relation to users, that "Needs of current and potential investors and other users should be met by including regularly and consistently in financial statements all material information which is available to the public from other

sources," and the audience participant asks this question, "Does NAA mean that it feels each issue of financial statements should include all the information which is included in various Securities and Exchange Commission reporting, 10-K, S-1, and so forth?"

Can you answer that, from the floor, Jack?

MR. JACK GIBSON: Not necessarily. It would be a precondition of something, but they don't necessarily mean that.

CHAIRMAN TRUEBLOOD: They do not necessarily mean it?

MR. GIBSON: It gets rather extensive.

CHAIRMAN TRUEBLOOD: Thank you. We will next hear from Laventhol Krekstein Horwath & Horwath, if they will take the stand. First, please introduce yourselves.

MR. STANLEY FERST (Laventhol Krekstein Horwath & Horwath): Thank you very much, Bob. I am Stanley Ferst and I should like to introduce my two partners next to me-- Charles Chazen from Los Angeles, and Bob Ferst from Philadelphia. As we indicated in our formal paper, we propose to speak on a very narrow, key section of financial reporting--projections and forecasts--a subject which has already received much attention this morning and which has very many unresolved problems today. Our firm feels strongly on this subject and is willing to stick its neck out, at least for the purposes of this hearing. We have selected Chuck Chazen to supplement our formal comments, and since he comes from California he must be regarded as an expert.

MR. CHARLES CHAZEN: Yes. As he said, well here goes my neck! We are going to talk about, basically, this very narrow subject in this overall conception of objectives and financial statements, the subject of forecasts and feasibility studies. There is no doubt that forecasts of financial information in all of the forms, projections, feasibility studies, budgets and similar presentations, are needed by the business community. We have heard that all morning and part of the afternoon. The use and usefulness of forecasts has been demonstrated. More often than not, doesn't the user of the financial statement, the investor, the analyst, the lender, view the historical information contained in the annual report primarily for the purpose of estimating and evaluating future results? To him, it isn't only important to know where a company has been, but only as a threshold as to where the company may be going. If this is the need which the financial community has, should not they have done for them on a professional, independent basis what is now done, in some cases, on a hit-or-miss or on a puffing basis? And who is better qualified than the certified public accountant to take this responsibility?

The supervision of the gathering and presenting of financial information into whatever form required is certainly the role of the trained and qualified certified public accountant, and when we consider the demands of the financial community for projected financial investment, we cannot overlook the investor, whether sophisticated or unsophisticated, who is seeking professional guidance and assistance. Here the

problem becomes more acute.

Let's take the group of investors who are considering the advisability and feasibility of constructing and operating a business unit, whether it be a hotel, a hospital, a shopping center or a glue factory. A feasibility study is generally conducted, for the specific purpose of determining a specific project for a specific service, of its suitability as measured in terms of specific financial success of the planned venture. Usually there are three aspects to a feasibility study--a market study, an analysis of the proposed site, and operating forecasts.

If the proposed investors have had experience in this business, they might attempt to forecast based on their own experience. Perhaps this might suffice for a small project in which the people putting up the money are willing to accept on faith the facts and figures gathered by the promotor who has had some experience in this business. But this limited information is similar to an internally prepared financial statement, and filled with the same risks of subjectivity. What sophisticated investor would rely on it?

As a rule, a well informed businessman will not risk his money on an idea promoted and developed solely by someone who lacks objectivity. Who will he rely on? The certified public accountant has demonstrated experience and knowledge, and with this experience and knowledge in the field covered by the proposed business is the only logical choice. As stated in our memorandum to the Study Group, there is no one better

constituted to guide the businessman in his preparation of forecast financial information and no one more acceptable as a credible reporter to the financial community than the certified public accountant. The certified public accountant's background, training and experience qualify him for this role. Add to this the certified public accountant's experience with and knowledge of a particular business and you can't beat that combination.

Unfortunately, some members of our profession, in judging what the role of the certified public accountant should be with respect to forecasts, allow their judgment to be clouded by the accounting problems related to forecasting and by the added potential liability exposure. Sure there are problems to be solved in both accounting and reporting, and liability exposure is surely a consideration. But if we are called upon to meet a basic, fundamental need of the financial community, we should not allow ourselves to beg off by saying we don't know how to do it or we are afraid to do it.

Let's first recognize that this need exists. Then we can cope with the other problems.

Certified public accountants have been associated with feasibility studies for years. Projections have also been products of certified public accountants' services. What then is our concern? We believe that forecast information prepared under an appropriate set of rules, should take its place with the other financial statements.

There has been growing evidence that the Securities and Exchange Commission and others are recognizing the need for and beginning to encourage the use of projected financial statements. The profession should not look at forecasts as second rate statements, but allow them to take their place with historical statements. The sooner this is done, the sooner forecasts, feasibility studies and budgets and so forth are recognized as needed tools, as numbers to be placed in the hands of the financial people and investors, the sooner our rules and standards will catch up with them.

Forecasts are now being used to a limited extent in prospectuses and other forms of selling documents. The Securities and Exchange Commission is making sounds that forecasts will soon be acceptable if not mandatory--again pointing toward the growing use of projected financial data. Like it or not, we are faced with this.

Turning to some of the more specific issues in forecasting, one of the difficult questions concerns the degree of disclosure of assumptions. Since forecasts are almost entirely based on assumptions as to the future, obviously a great degree of disclosure would be required. We believe that financial projections should ordinarily be stated in terms of a range of possible results related to different significant assumptions, rather than present single amounts. The use of single amounts in historical financial statements has, in our opinion, resulted in the user ascribing a degree of precision to the statements which is more than that intended. This is even

more dangerous in forecast information.

The use of a range should help to avoid unwarranted reliance on the forecasts and also provide the user with the ability to assess the impact of the outcome of various assumptions. Many have suggested that probability techniques be used in expressing the likelihood of forecast results being attained. We suggest that additional experimentation and evaluation of this technique is necessary, particularly concerning the use of subjective probability measurements.

We have used the terms "feasibility study" and "forecast," and said earlier that "feasibility study" is a broader term than "forecast," since the feasibility study includes all the development work leading up to a forecast, as well as the forecast itself. Considerable judgment is involved in developing both of these processes, and the process is not wholly unlike that of an audit. Generally accepted forecasting standards are required to insure even a minimum degree of reliability. The field of forecasts and projections must be acknowledged as a certified public accountant's function. Yet, if we hesitate too long to make this acknowledgement official, there are others standing in the wings ready to step in.

At the Securities and Exchange Commission hot-issues hearings held earlier this year, representatives of a private company outlined a procedure where the company would operate as an objective and unbiased authority to determine that projections, including the prospectuses, are, "reasonably prepared," and, "appropriately qualified." One of the signifi-

cant comments made by this group was the following, and I quote,

"Serving as intermediaries in the financing process are legal, accounting and other advisors who counsel issuers, underwriters and, at times, investors. And yet none of these professional groups in the United States has come forward to voluntarily assume responsibility for evaluating projections and prospectuses, nor, in our opinion, is any likely to do so."

In summary, one of the objectives of financial statements should be to present projections when this information will be useful to investors, creditors and other users. The forecasting situation is clearly one of demand and supply.

Understand that the business community undeniably is demanding forecasts of one form or another. In our opinion, our profession should be ready, willing and able to serve this need.

CHAIRMAN TRUEBLOOD: Thank you, Chuck, very much. You did very well. Incidentally, I wonder if I could ask you to expand just a little bit on this degree of precision which you have rightly brought into your paper. I am certain, today, we all agree with you that the degree of precision is far more difficult with respect to forecasts even of cash than it is with respect to income. But, do I properly infer that this degree-of-precision problem is sort of pervasive in terms of all financial reporting? Did you intend to make that implication?

MR. CHAZEN: Well I said that it is even more important in historical statements where precision is sometimes taken for granted. It seems to me that I remember in some recent testimony, in a case where a young associate college professor, when asked whether in his opinion financial statements, when fairly stated, meant that every single figure in those financial statements was accurate and exact, he testified, "Yes, that, obviously, is something that professional accountants don't believe and know is not so." But unfortunately there is a degree of inference that a reader sometimes takes when he reads a financial statement. What's even more important in projections is to make sure that the reader is not misled.

CHAIRMAN TRUEBLOOD: Do you think it appropriate somehow or other to work into a statement of objectives that all we can hope for in forecasts, or anything else, is a reasonable parameter of precision, or a reasonable approximation of results, as distinguished from the preciseness which our public expects--not only the untrained public? Would that be a reasonable inclusion?

MR. CHAZEN: Yes. That's why we suggest that a range of figures be given, rather than figures in the absolute, so that the reader cannot do so.

MR. WAGNER: May I ask, what are you referring to, in terms of this range? What are the parameters? What is an accepted degree of tolerance in connection with our future projections?

MR. CHAZEN: Well it seems to me this is one of the things we are advocating--the establishment of these standards to determine what the degree of tolerance should be. If you are asking for my opinion, let me answer it this way. In a feasibility study, when we are asked to tell an investor what we think about a particular investment, we frequently couch our report in terms of levels of attainment. In other words, if it's a hotel, we say, "At 70% occupancy, you might expect this result; at 80, this result." We aren't telling him he is going to have 80, 70 or 90; we are saying that, if it were so, this is what you might expect, based on our survey and market studies, and so forth.

In terms of a going concern, I am not sure whether we can really establish parameters or perimeters for determining, or for saying to the accountant or management, "Stay within these bounds." I think that each business has to be assessed on its own.

CHAIRMAN TRUEBLOOD: Well, in terms of your illustration, if you were to tell an investor that, with 70% occupancy, his earnings should be thus and so, with 80% it should be so and so, and with a 100% it should be so and so, how will this help the investor to make up his mind whether to buy or to sell, in a particular business.

MR. STANLEY FERST (Laventhol Krekstein Horwath and Horwath: For the purpose of this illustration, we would give the investor enough information so that he could draw his own conclusions as to what the reasonableness would be, in his

mind, of achieving 80% or 70% or even 90%, and he would be armed with enough facts so he could draw his own conclusion before he made the investment. This is exactly what takes place, not only with respect to the investor but more significantly with respect to the insurance company that puts up the money.

MR. PARKER: I thought I gathered from your comments that the accountant was going to pass on what level of occupancy should be reasonably expected.

MR. CHAZEN: No, no, no! We conduct a market survey, we do many things in a feasibility study. We know trends and operational statistics in the industry and therefore would be able to put together a forecast that is reasonable, as reasonable as it might be, as a forecast projection. But we don't tell the client, "You can anticipate 80% occupancy."

MR. PARKER: But when you are asking management to make a forecast of what its business is going to be next year, within reasonable limits--I gathered from what you said that the accounting firm is going to pass on the reasonableness of those assumptions...

MR. CHAZEN: We are talking about two different subjects. We think that a going concern with a track record is in a different position than a brand new venture. Obviously a brand new venture has nothing to rely on but the site it has and surrounding community and the statistics for the industry, while a going concern has a history on which we can rely. It has contracts, it has a product, it has management,

it has a market, and all of these should be taken into account.

Now as far as the reasonableness of the assumptions, I think that a competent auditor, qualified with this particular client, in this particular industry, can be expected to have a degree of competency to determine--let the assumptions be management's, where they rightfully belong--whether or not the assumptions are reasonable.

MR. PARKER: As far as what the economic developments will be next year, whether the gross national product and car production will be up this much?

MR. CHAZEN: That's right, that's part of it.

MR. PARKER: Accountants have this ability?

MR. CHAZEN: I believe accountants have it, or have access to it, yes.

MR. STANLEY FERST: As to the reasonableness of it.

MR. PARKER: And suppose some client says, "We are going to be up 5% next year," and the auditing firms says, "No, you will be down 5%"? How will you resolve this question?

MR. CHAZEN: You haven't given me enough facts to be able to resolve it. A tolerance of 5% is relatively narrow.

MR. PARKER: Yes, but when it begins to be a question of up or down, "Will hotel occupancy be 85%, up from 78, or will it be down 4%?" and you feel very strongly that it might be down.

MR. CHAZEN: Well, isn't this really the same problem with reference to bad debts? In other words, management says to me, "I think this kind of an allowance is sufficient."

The auditor makes a judgmental decision; he does it all the time, and says it is or it isn't. I think he bases that judgment on the very same experience that allows him to make that judgment you are talking about.

MR. PARKER: So your judgment wins out over his?

MR. CHAZEN: Well, I don't know that it wins or loses. I think that the auditor is in a position of an advisor, like he always is.

MR. PARKER: I am just wondering if it isn't a little more important to the manager than a decision about the reserve for bad debts.

MR. CHAZEN: If management can prove or can justify what management says is so, then, like the financial statement, it was justifiable and the auditors must accept it. If he can't justify it, or if the auditor can poke holes in it...

MR. PARKER: But, what is the criterion for the justification? Who is the arbiter? Who knows more about the subject?

MR. CHAZEN: Well the auditor, for example, has shown that sales are anticipated to increase by 20% next year. Why? Because we have developed this product that already has created this many contracts, and based on our experience, management says we can anticipate these additional contracts during the coming year.

Well we look at the history and we either agree or disagree. We may say to management, "But, the last five years have not shown this to be so." You know there is no right or

wrong, but this is an area like we always face as auditors, where we will have to get together with management and somebody will have to prevail, based on good solid judgmental evaluation. I don't think it's any different from an inventory obsolescence problem, or similar problems that we face today.

MR. PARKER: Have you had many managements asking you to help them in this way, in forecasting their future operations?

MR. CHAZEN: Our experience has been principally in feasibility studies.

MR. PARKER: I gather that they are two quite different things.

MR. CHAZEN: Yes.

CHAIRMAN TRUEBLOOD: Much of the conversation and presentation, I believe, related to what we might call feasibility studies in the management service area, as distinct from forecasts, more broadly, as we were discussing this morning. This leads me, however, to a question from the floor on this basic assumption, which I would like to direct to Stan Ferst: "Since the Institute's Management Advisory Services Committee has taken the position that we cannot determine whether assumptions are reasonable, how can we, as professional accountants, be taking the position that we can get into the forecasting business?"

MR. STANLEY FERST: I think it's a little bit unfair, because the person who framed the question might have been eavesdropping at our luncheon session! We tried to answer

this question ourselves before it was asked. To be perfectly honest with you, I was really amazed with the position of the Management Advisory Service Committee, having chaired the special ad hoc committee, I think, on executive recruitment for a fee. As you well know I was much involved in it, and the MAS people were the ones saying that it would not affect our independence.

I think maybe it was Arnold Levine from Lasser who said he would be willing to accept one thing at a time and be willing to progress piecemeal, and I hope we'd go along with this also. We would hope that in the not-too-distant future we could find rules so that we could attest to the reasonableness, as well as the compliance aspect, as well as the exemption aspect in the preparation of projections. But if we had to start with one and then ultimately down the line settle for the next one, this would be satisfactory too, because we'd be moving in the right direction.

CHAIRMAN TRUEBLOOD: But, there does seem an inconsistency...

MR. STANLEY FERST: Yes, correct.

CHAIRMAN TRUEBLOOD: ...between the MAS position of some years ago and their present position.

MR. STANLEY FERST: I just couldn't believe it, Bob.

CHAIRMAN TRUEBLOOD: And this leads me to another question, which also comes from the floor--twice, as a matter of fact. The question, if I may paraphrase it, making a single question out of it, is basically this--given that the auditors

have forecast earnings--however we handle the assumptions and ranges--can they then be objective, in the independence sense of the word, when they get to the formulation of their auditor's opinion on financial statements? From the way the questions are written, there is some presumption that even the auditor would look better if he had given his opinion on roughly similar results.

MR. ROBERT FERST: I don't think we have much of a problem. The auditor is constantly giving advice. Thirty years ago we recommended one adding machine as against another one. If it didn't work out, then we were in trouble. I think the question of independence really doesn't enter into this even though it has been raised in a number of instances. I think we do projections, we do feasibility studies, and we can still be independent in our audit.

MR. GELLEIN: Much of your paper and many of your comments have concerned feasibility studies. Just to be sure we understand your position, I have a series of questions. Not to lead you down a primrose path, I will state all of them at the same time.

MR. ROBERT FERST: Ask the last one first!

MR. GELLEIN: Question One, is it your view that forecasts should be included as a basic part of financial statements or as supplemental information thereto? Question Two, if "Yes," would you have this as a requirement for all companies--small, large, public, private? Question Three, if so then what would be your views about updating this information?

You know, we haven't gotten into this subject, yet. Would you prepare forecasts for the budget at the beginning of the year and update it, say, every thirty days when it has been revised? Maybe you would need to update it every month.

Now, this is the series of questions, and I wondered if you'd like to comment.

MR. ROBERT FERST: The first question, "Should it be a requirement for all reports..."

MR. GELLEIN: Basic or supplemental?

MR. ROBERT FERST: We have a distinction between companies who report to outside shareholders, or the so-called publicly owned companies, as against the small, privately owned companies. I think that forecasts or projections are an important factor for the publicly owned companies. It may not be required for the small corner grocery.

Your question, I think, Oscar, was in connection with whether it should be part of the regular financial, or supplemental...

MR. GELLEIN: Yes.

MR. ROBERT FERST: And I really don't much care. This is "format." Your second question was on the updating.

MR. GELLEIN: Well, the second one, you have already answered it, I think. The third one is "updating."

MR. ROBERT FERST: On the updating, yes, I think updating is required, the same as you come out with quarterly statements--and here again I distinguish between the publicly owned and small, privately owned company--but the publicly

owned company reports quarterly, some semiannually, some monthly even, and to the extent that there is information that belongs to the public and to their shareholders, they should update this as promptly as possible, and this would include projections and forecasts as well as financial statements.

DEAN DAVIDSON: As to this requirement, even for public companies it might not necessarily be required that it be shown, and it would probably be sufficient, in the accountant's opinion, to say, "No, the company does not have a forecast available for publication,"--that they do not do any advanced planning.

MR. ROBERT FERST: Well...

MR. CHAZEN: I wonder if that really is a solution. Wouldn't you then find that whenever they have something good to say they'd say it, and when they didn't, they wouldn't? Allowing them to be selective would probably defeat the entire purpose of the forecast.

DEAN DAVIDSON: No, I think this would probably suffice to say, in the bad years, that the company is not making it.

MR. WESTON: Much of the input to our Group, particularly from the management side, raised serious questions about forecasting--the management first, and then the certified public accountant reporting on it, second. Would you have any views as to how that could be handled and this objective implemented?

MR. CHAZEN: I have no opinion but I think number one, if the profession had rules or standards whereby the practitioner could be guided it would be more than a plus or a minus--it wouldn't be the solution, necessarily, but it would help him. Second, the projections should be made in such a fashion so as to make sure that nobody could misunderstand them as absolute projections of the future. That also is important. And number three, I think that this updating process Bob described is extremely important. I think that whenever a public-owned company reports to the public, whether it be quarterly or on any basis, that as a part of the historical figures to date an updating of projections must be made to indicate its temporary nature. I don't know if there is any absolute solution against liability--I was hoping you fellows would find it.

CHAIRMAN TRUEBLOOD: Well, the question Frank has raised has been also raised from the floor. I'd like to comment first that whether or not it's presently an objective or a requirement, it is common practice for quarterly estimates to be made by certain companies presently, both with respect to sales and earnings, so this whole bit, except in its disaggregation, is not quite as new as we sometimes think it is. But, we have learned legal counsel with us, who is familiar with the British practice and has already done some work on this. Would you care to make any statement, Dave, about the liability problem as it exists in present practice and as it might exist under an extension of present practice?

PROFESSOR HERWITZ: Well, we are still in the midst of collecting the data that is available, and much of it you have seen in the press, in dribs and drabs. As the cases have been developed under the securities laws, I think there is no reason to quarrel with the traditional view already referred to, that forecasts cannot be treated as warranties of the future. Hence, it would be improper--and one may hope the law will see it the same way--to impose liability on forecasters merely because the events turn out differently.

On the other hand, it certainly must be assumed that with a requirement of forecasting or even with a development on a permissible basis, there will be increased scope of potential liability for the time being, in the present temper of the times. As you are all very well aware, forecasting does present an inviting target when the events have gone awry, and the increase of litigation, whether that involves management or accountants as the defendants, would cause an uncomfortable period. It may not be too high a price to pay.

The most recent case in the field, for such interest as it may be, involved projections made by Monsanto. For 1965, there were regular projections which were quite on target. For 1966, projections were publicly made, again to analysts and to the press. As to the first half of 1966, right on target; as to the second half, significantly off. A modest business recession, which Reed tells me I must refer to as a "mini-recession," which hit the chemical companies, including duPont, threw the projections off.

In an action brought by complaining stockholders, the trial court, rather recently, has taken a very strong view that there is no liability. In effect, the court indicated that there is no liability just because the forecast turned out to be inaccurate, since the management--these were management forecasts, in this case--had been careful in assembling the data, sensible and reasonable about their assumptions and had updated as promptly as the circumstances and changing events would call for. That's a rather favorable omen.

On the other hand, there was litigation, and that means that some considerable number of Monsanto officers and directors are having an uncomfortable time.

CHAIRMAN TRUEBLOOD: I see Andy Barr in the room. It is my recollection, Andy, that the earlier Wheat Report rejects the inclusion of forecasting, because of the presently stringent liability requirements of Section Eleven of the 1933 Act...

MR. ANDREW BARR: That's correct, yes.

CHAIRMAN TRUEBLOOD: ...with the feeling that they would have to be adjusted for the kind of thing Dave was talking about. Is that right?

MR. BARR: Yes.

CHAIRMAN TRUEBLOOD: I have another question from the floor which I am going to toss to Reed. It says, "Don't you believe forecasting by the accounting profession encroaches on the financial analysts' program?"

MR. PARKER: Well now, my biases are all going to get

exposed to the "court"! I think that professionals talking about other professionals encroaching in their territory gets to be silly and I think it's not a good kind of thing to talk about. But I think I would honestly have some feeling, at root, some question, in a way, as to whether the typical accounting firm can bring to bear here what is required, or at least what financial analysts presently use.

I cannot think of a single analyst in our firm who would dare to begin to start to make a projection about what Company "X" might do next or this year, or for the rest of the year, without a careful study of an enormous number of macro-economic data, interviews in person with as many of the competitors of this company as practicable, whether they were audited by one firm or another or seven different firms, and customers and suppliers. He would also put into the picture feelings about the strength of the management in various areas based on personal interviews with them over the years, and visits with managements in numbers of companies. All this would be done before he got down to the company in question. I wonder whether time and the ability to do this rests in the accounting profession. For example, each company in the auto industry expects to increase its share of the market. Well, you have to talk to each one of them before you find this out, and you know that somebody's assumption cannot be correct. And is this a degree of existing expertise, or would it have to be built? And if it has to be built, how much does this cost the client company, and is this the right cost-benefit

ratio for this kind of information? Indeed, I would be just the devil's advocate in asking this last question, but I have heard it raised--is this offer of accountants to evaluate forecasts and even to evaluate the assumptions for them, is it not just a looking-for-more-business kind of a thing?

MR. STANLEY FERST: Well, first of all, any competent management is constantly making forecasts. We believe, and it's been said here many times today, that this information should be shared with the investors, with the owners of the business, and we further believe that somebody has to add a little bit more credibility to it so it won't be one hundred per cent self-serving.

Now as professionals we are constantly called upon to give a certain opinion on various things. We can, as we have indicated, attest, ultimately, to the reasonableness of what management must, we believe, share with its investors. I don't know who else they should go to. Just to abdicate this to somebody else, I think, is foolish. To abdicate it to the FAF, I think, would be silly on our part.

MR. CHAZEN: I am not so sure that the analyst's end product is made available to the general public; it may have been made available to his customers, I don't know, but the general public is continually bombarded by management estimates of the future. That's what the public sees and relies on. And if our role is truly to be public accountants, it seems to me that we have an obligation, both to our partners and to the public, to sort of censor this information and

put it in proper perspective based on our experience.

Sure it will add to the cost of the audit--so did the addition of the statement of changes of the financial position. The clients ought to get it from the best source possible. And, in our opinion, the best source in this case is a certified public accountant.

DEAN EDWARDS: In the last paragraph of your paper you indicate, as a broad objectives category, that we should recognize the need for projected financial statements and feasibility studies and that they should be included under the attest function. Are you making a distinction first of all, between projected financial statements and feasibility studies and, secondly, would you include all feasibility studies, those that were accepted by management and those that were rejected by management, as part of the attest function, and reports rendered on them?

MR. CHAZEN: Well, these are two separate fields. The paragraph that you read from--I don't see any reference to the attest function in that paragraph.

DEAN EDWARDS. Well--yes. If you look at the...

MR. CHAZEN: Well, yes, but, not in the same context. We are talking about forecasts for going concerns as a part of annual reports, as a normal, standard thing. We are talking about feasibility studies separate and apart, and also being subject to certain rules and regulations and guidance, so that all accountants reporting on feasibility studies report in the same manner and are guided by the same principles.

Whether or not a feasibility study is circulated to the public depends upon its purpose. For example, let's say right now, there are land companies subdividing land for the first time, with no previous history, no previous track record, who want to sell shares in their company to the public. They have to tell the public what they can be expected to do for the next five years, so they have forecasts prepared. These forecasts are prepared, based on I am not quite sure what. They aren't feasibility studies, but they are prepared for companies having no previous experience.

Whoever is involved with this kind of forecast should be bound by the same rules and guided by the same guidance that this Committee is going to present, and all I am suggesting is that instead of accountants, qualified and capable and competent as they are, going their own ways in feasibility studies or in forecasts, that they should be all in the same boat with a standard approach to all of these things.

CHAIRMAN TRUEBLOOD: It seems to me you guys have hit upon today's hot issue. I have more questions from the floor than I can use, and I am going to restrict myself to two more, and then let you go. One of these has to do with the attitude of management. Our written input on the subject of forecasting has about a fifty-fifty split on the reasons why it should not be used. Some say that management will always make so conservative a forecast that they can always better it. The other objectors say that they will make a highly-nonconservative forecast in order, hopefully, to improve

their stock position. So the question really boils down to "Is it your position, or in your judgment, would the establishment of standards and the requirement, as an objective, of publishing forecasts with some degree of surveillance improve the circumstances, as we presently find them?"

MR. ROBERT FERST: Bob, I think your question as to which way management should go was raised by Professor Davidson a little while ago. It's a question of whether the bottle is half-full or half-empty. You will have management going both ways. But there is no question in our minds that if you have standards with someone looking over your shoulder, you will get a fairer view than either by puffing it up or blowing it down.

CHAIRMAN TRUEBLOOD: Then the final question, in two pieces. The first has to do with updating, which I think you have largely answered; you have presumed periodic updates, and, since even the federal government has come around to a periodic updating of its budget, I can only presume that this, in history, might be as forward-looking. Would you agree with that?

MR. ROBERT FERST: I agree with that.

CHAIRMAN TRUEBLOOD: The final question is, then, "What about cost?" In all our objectives, we have to concern ourselves with the cost-benefit ratio. I presume you have touched upon this: that, really, management already have forecasts internally, and all you are asking for is publication. But nonetheless, it would be a different kind of use, and what is your judgment about incremental costs in this

procedure should it be required?

MR. STANLEY FERST: Well there will be incremental costs. I don't think for the purpose of this Study Group's report that this has to really be a major item for it to consider at this time. I think that this report will ultimately be long-range, as most of your most recent works have been, up to date, and I think we will have to grow up to whatever the costs will be.

MR. CHAZEN: Well all of us, I am sure, have conducted audits from time to time, and if we were to consider this as merely a part of the cost of the audit functions, the costs will be not as prohibitively high as the cost of the end product we expect to arrive at.

CHAIRMAN TRUEBLOOD: We think the entire group would be unanimous in saying that anything we come out with by way of an objective cannot be considered apart from implementation problems. And I think I might also say for the Group that we are constantly concerned about how much cost can be put upon the business community in order to accomplish objectives, however desirable.

Well, thank you very much for a spirited and lively discussion. We are now going to hear from Donald Etra, from the Corporate Accountability Research Group. Donald, if you care to say anything about your group, by way of background information...

MR. DONALD ETRA (Corporate Accountability Research Group): The Corporate Accountability Research Group is a

public interest research group, working down in Washington, organized by Ralph Nader. The Corporate Accountability Research Group feels that a primary objective of the accounting profession should be to serve the public. By serving the public, we feel that accountants should be responsive to an audience which is comprised not only of shareholders and creditors, but also labor, which is interested in knowing whether it's getting a fair share of profits; consumers, who want to know if they are paying an equitable price for goods; the government; and scholars as well. And, therefore, we ask the accounting profession that, when it comes down to a choice of the new Financial Accounting Standards Board, that the new FASB should be representative of all the interest groups. We feel in order to serve the public the accountant must be independent, and in order to be independent we do not feel it possible both to give advice and then to evaluate the results of having followed that advice. Therefore we would like to propose that the major accounting firms and all accounting firms divest themselves of their management consulting services. At the very least we feel that if an accounting firm performs both consulting services and accounting service for the same corporation, that fact should be stated in the accountant's certification, and the Corporate Accountability Research Group is prepared to propose that to the Securities and Exchange Commission. If you do both services, at least state it. In the best of all possible worlds, the accountant's function should be restricted to accounting and not management consulting.

We feel that accountants can further serve the public by joining in the fight for greater corporate disclosure. These types of disclosure should include product-line reporting: how well does a large conglomerate do on a department-by-department or company-by-company basis? We think we should no longer kid ourselves. This information certainly is available internally. As many of the gentlemen described this morning, if one person is in charge of a department and he doesn't know how profitably that department is doing, he is not going to be around too long. We feel that corporate disclosure should also include items like product-safety data. This might be the area of social cost-accounting, but it's an area of social cost-accounting which is easily quantifiable. Have the products which a company produces been successful on the market, or have these products caused considerable consumer injury? I think this is material, not only in the humanitarian sense but also in a concept of pure profit, because if a Ford Motor Company produces a defective car that causes "X" number of accidents per year, I think the shareholders have a right to know that, and that information properly should be found in a financial statement in a corporation's annual report.

We feel that accountants and the accounting profession should recognize some of the newer concerns of your constituency, that is, the public. This includes environmental concerns, concerns of whether the corporation is being a good citizen or whether the corporation is embarking on a program of indiscriminate pollution. If this type of information

might be too bulky to be found in an annual report, then at least state what information is available.

Before the Securities and Exchange Commission this month is a proposal that the 10-K Form should state what's in the 10-K that isn't in the annual report. We feel that there is greater necessity for telling the shareholders what's in the 10-K Form filed with the government that isn't in the annual report, and more importantly, why that information isn't being given to the shareholder.

We feel that financial statements should be understandable not only to the trained user. There are thirty million investors in this country, and I think if we restrict that group to what was phrased this morning as the "trained user," the function of accountants would be limited to maybe a handful of people beyond the people in the room today.

One way to make the statement understandable is to eliminate unnecessary jargon: words like "pooling" or "flow-through methods." Fine, we understand them. But for a layman I am not so sure these words convey their real meaning. If the jargon is necessary for ease of expression, at least state somewhere on the financial statement what these expressions mean.

In order for financial statements to be understandable, we feel that there must be a greater degree of comparability between the financial statements of various firms, especially statements of firms in the same industry of comparable size. In order for them to be comparable, we recommend

uniform accounting principles. By that is meant that there should not be more than one method to describe the same economic event, without justification. That is, the burden should be shifted to corporate management to justify why a method was chosen rather than the present situation where five or six alternate accounting methods are available, and management can choose at will which method it wants to use.

We feel that the accounting profession, the private profession, should take note of the Cost Accounting Standards Board which, along with the General Accounting Office, completed a two-year study on the feasibility of uniform cost accounting standards for one segment of the economy--defense contractors. The conclusion of that study was that if uniform accounting principles were implemented, the private taxpayer would save two billion dollars because defense contractors would have to state the accounting methods they used; they'd have to use uniform principles; and they could not get away with some of the practices they were indulging in--specifically, things like double-accounting. "Double-accounting" means that if something costs a manufacturer twenty-three cents, charge the consumer forty-six cents, because, say, twenty-three cents is the direct cost, twenty-three cents for indirect costs, and just forget to tell him that those indirect costs refer to the same thing as the direct costs.

Therefore, we feel that uniform cost accounting and uniform accounting principles are necessary. Specifically, in areas such as inventory valuation and depreciation, we feel it

is very important for accounting rules to reflect reality. We ask that every accounting opinion, every former APB opinion and every new opinion of the Financial Accounting Standards Board be subjected to two tests: firstly, a common-sense test; does the opinion, does the accounting rule describe an economic event which happened? Or is it something like what's known in the law field as a legal fiction? It didn't happen, but we'll call it that, anyway.

If an accounting rule, an opinion, does not meet a common-sense test, then we feel that opinion is not valid. We further feel that every accounting opinion should be submitted to a functional test: will the use of that rule change the behavior of the firms which use it? If so, we feel that the accounting profession must take responsibility for that changed behavior.

To give an example, let's subject the APB's Opinion 16, referring to pooling techniques, to both the common-sense test and the functional test: does it describe what happened? Will the rule change the behavior of those who use it? Well as you know, if one uses the pooling technique one can carry over the historical cost basis of the acquired firm, adding the historical cost to one's own balance sheet. In simple terms, if a company is carrying its old assets at five million dollars, although worth ten million dollars, and the new firm has assets of ten million, we can get a result that "ten plus ten equal fifteen."

Now if I had a trained mind, I guess I could under-

stand how ten plus ten equals fifteen. But when the layman reading the financial statements comes across something like pooling, he wonders how ten plus ten equals fifteen, and I think we ought to respect the man's opinion that, forever, ten plus ten equals twenty.

I think when we subject the APB Opinions to the functional and common-sense tests, the inadequacies of some of the underlying rules will be uncovered--specifically, the use of historical costs. It was very interesting to read the statement of Ernst and Ernst stating that historical costs provide satisfactorily current data. Well, that's good to hear--I just hope Ernst and Ernst didn't try to get on the subway this morning and pay only fifteen cents for a token now worth thirty five cents, and I do hope Ernst & Ernst has come this afternoon and will pass out cigars under the assumption that cigars still cost five cents.

In short, historical costs should be part of the accounting profession's history, and not something which is still a viable technique in the Twentieth Century. We feel that the exciting challenges of the accounting profession lie in the new areas, not areas of trying to figure out how many different ways there are to describe the same event, but areas to develop new interpretive analyses to describe the type of social concerns that are expressed within the population.

Are these concerns real? First National City Bank just completed a study showing that shareholders would sacrifice 10% of returns if they could see that the moneys were

invested in companies that were good social citizens, companies that did not pollute, companies involved in inner-city projects. Take, for example, Chase Manhattan Bank's new annual report, which has a whole section on social cost-accounting, describing the Bank's involvement in New York City. According to David Rockefeller, "Everyone is always going to agree that 'all banks are bad,' but at least if we have a social sector in our annual report, we will be the 'least baddest'."

Are social cost-accounting concepts quantifiable? Yes, in many cases, such as information on product safety. That's quantifiable--how many claims have been brought against the company in a particular year.

I think if annual reports and if financial statements dealt with some of these social issues, maybe more people would open their envelopes when the annual report reaches their homes. I know that in the Corporate Accountability Research Group we open every envelope with an annual report. We are so fed up because those reports don't state the amount of deaths caused because the company wasn't following occupational health and safety guidelines.

Just recently we put out our own annual report of a company putting out its own annual report, itself. Our annual report dealt with the type of pollution the company is foisting on its communities, with the types of health and safety regulations the corporation is avoiding, and I think the shareholders perhaps learned just as much from our annual report as from the annual report of the company that's actually involved.

We see as an exciting challenge for the accounting profession the development of the format of an impact statement to be included in every corporation's financial report, or every corporation's annual report. These impact statements could deal with the environmental impact of corporations, similar to the requirements in the National Environmental Policy Act requiring environmental impact statements of federal agencies.

So these are some of the new projects of accountants. I'd like to close with the suggestion that more accountants get into the field of public interest accountancy, as the other professions: medicine, where doctors serve time in clinics; law, where there are public interest law firms and legal aid societies. Similarly, accountants should take their place in the professions that do devote time to social interest and to public concerns. Certain law firms around the nation are organized on a public interest basis. Every student, in particular states, increases his tuition three dollars. This money is pooled and some of these funds have come up to about two hundred thousand dollars, which can fund a five or six man public interest law firm.

We suggest that accountants get into the same type of activity, as we heard earlier this afternoon. The Accountants for the Public. Why not? Each state accounting society should try to organize a public-interest accounting firm. These accounting firms could be the renegades of the industry but could also be the vanguards of the industry, to point new

directions and serve the public interest.

Thank you very much.

CHAIRMAN TRUEBLOOD: Thank you, Mr. Etra--a very lucid and good presentation. I would like to put into the record that a significant number of the larger state societies, as distinct from the American Institute, do now have what might be called the equivalent of a public interest accounting firm, especially and particularly designed, however, for assistance, both in the sense of auditing and management services to minority groups. I think we did come along late to our misfortune, but I think we have started this route, and I fully agree with your position that we have not done enough.

I have two questions for you before we open this up. Do you happen to be familiar with the recent CED report on the social responsibility of business corporations?

MR. ETRA: Yes.

CHAIRMAN TRUEBLOOD: Does your group take a neutral, positive or negative position about the general line of this report?

MR. ETRA: Could you be specific as to the proposals in the report?

CHAIRMAN TRUEBLOOD: Well, it kind of says we should be going further, but it doesn't get very explicit, and I was just trying to relate it, if you happened to be familiar with the report, to...

MR. ETRA: We feel there should be a definite degree of explicitness. For instance, a corporation in making a move

that would affect the environment has to file a report with a federal agency. We feel that a summary of that report should be in the corporation's annual report.

CHAIRMAN TRUEBLOOD: Yes?

MR. ETRA: We also want to emphasize that we are aware that technologies are present to make these possible. For instance, pollution data is quantifiable, and with some degree of interpretation in prose that would be possible.

CHAIRMAN TRUEBLOOD: So what you are saying is that you do not disagree with the philosophy?

MR. ETRA: No, we want to go further.

CHAIRMAN TRUEBLOOD: You want to go further?

MR. ETRA: Yes.

CHAIRMAN TRUEBLOOD: So that there is more information to the public?

MR. ETRA: Yes, to the public.

CHAIRMAN TRUEBLOOD: That brings me to my second question which I think underlays a number of things you have said, and between you and David Herwitz maybe you can help me out a little bit here. Much of what you ask for by way of information to the public raises the question about what information is a private good and what information is a public good, in my lay version of the legal sense of those words.

Are you saying that there are really no restrictions whatsoever on information that a management might be required to release?

MR. ETRA: Management should have the burden of show-

ing why the restriction should be present.

CHAIRMAN TRUEBLOOD: If you were a manager, what would be the line you would draw on disclosure of such information?

MR. ETRA: That if I had to disclose it I would not initially develop it.

CHAIRMAN TRUEBLOOD: If you "had to disclose it"?

MR. ETRA: The so-called trade-secrets doctrine.

CHAIRMAN TRUEBLOOD: I see.

MR. ETRA: However, I would like to emphasize we do feel the trade-secrets doctrine has been abused by private industry.

CHAIRMAN TRUEBLOOD: It's used as a rationalization, in your view?

MR. ETRA: Yes.

CHAIRMAN TRUEBLOOD: All right, let's move, then, for an analogy, over to a hospital. Typically, hospitals have an internal "tissue committee," whereby a group of doctors, in effect, appraise the validity of surgery done by each. Should that kind of information be in the public domain, or should that be proprietary to the hospital and doctors involved?

MR. ETRA: I am not sure I follow the gist of the question--what information: the vote of the doctors?

CHAIRMAN TRUEBLOOD: The vote of the doctors. Let us say that a particular tissue committee finds that 10% of the appendectomies performed during the year were inappropriate and should not have been done. Is that a matter of public

information?

MR. ETRA: Definitely, definitely. I definitely think it should be. If I were considering an appendectomy I certainly would take that into consideration.

CHAIRMAN TRUEBLOOD: Would you carry that analogy, which may not be apt, over to business? Your line of distinction about public information is extreme.

MR. ETRA: Before I buy a Ford, I want to know if they are putting on a five-dollar bracket, so I have a hundred miles before I know my car will collapse before fixing my car.

MR. WESTON: Will you clarify a position of your report on page 11 where you deal with the functional versus common-sense test in terms of financial reporting. To return to pooling in your example you used earlier, supposing it were decided that poolings, in fact, did not pass the common-sense test; therefore, they should be outlawed. Should we then, under your idea of a functional test, examine the behavior of industry and determine that mergers would then not take place and evaluate that from a social-good...

MR. ETRA: I think an opinion must pass both tests before it becomes an opinion. What sometimes happens is that it might pass the common-sense test, but not enough thought has been put into the functional test. For instance, in Mr. Mautz' recent article in the Harvard Business Review, he said that if the pooling opinion went further, imposing a size test, or eliminating pooling as a viable technique, it would do more to curb the rampant merger movement of the Sixties

than anything that Justice or the Federal Trade Commission could do.

Now considering this from an antitrust point of view, retaining a society where competition exists, where people have the opportunity to buy goods at reasonable prices, where grades are determined by quality, not simply because it's only one manufacturer, I think if accountants are to go on to pass an opinion, that that is going to have to have a behavioral effect. Accountants must take the responsibility for that behavioral effect, or cop out to the Federal Trade Commission.

CHAIRMAN TRUEBLOOD: How would accountants decide which is a proper social goal, in that example? Should we decide whether mergers are good or bad--or, who decides?

MR. ETRA: I think you have to at least take it into consideration.

CHAIRMAN TRUEBLOOD: But, how do we decide whether mergers are good or bad?

MR. ETRA: You would trace the history of mergers in this country and you would see what would happen when you have competitive industries as opposed to when you have monolithic industries. Incidentally, there are colleges and universities that have put out studies. I think these should be taken under consideration.

CHAIRMAN TRUEBLOOD: This is probably one of the few papers urging that an objective of accounting should look at the results on society, rather than just reflecting what

we might call the economic realities in terms of several papers, and I am rather disturbed that you would move the accounting profession and objectives into that subjective determination. I think it's fraught with tremendous danger.

MR. ETRA: It is.

CHAIRMAN TRUEBLOOD: Political goals and social goals change almost monthly.

MR. ETRA: The responsibility is there whether you accept it or not.

CHAIRMAN TRUEBLOOD: But how will that be evaluated, say by a court? Suppose the profession decided that mergers were good, and therefore pooling would pass that test and may not pass the common-sense test? We would then evaluate it, somehow, and then go forward. I just can't believe those two objectives aren't contradictory, in a way.

MR. ETRA: Well I think the responsibility is there, and there is no way of ducking it, in a sense, because what you do will have an impact. The question is, "Should you consider that impact, or ignore it?" My recommendation is to consider the impact and take the impact into account before you make the opinion. And as men of integrity and honest men and intelligent men, I believe the accounting profession, as it retains its independence, can come up to some valid judgments. If the population as a whole feels that the accounting profession has made a mistake, there is always the check of the Securities and Exchange Commission.

MR. PARKER: I think Frank's question is quite

important. You almost touched on it there at the end. If you asked the accounting profession to make these judgments, which heretofore have been made in the halls of Congress or the courts, where the people can lay hands on the deciders if they don't like what they are doing. If the accounting fraternity does something you don't like, how can you lay hands on them? You don't elect them, you don't hire them, you don't have anything to do with them. And you'd let them make decisions affecting behavioral aspects affecting you and the general public. Yet you have no claim on them, no way to reach them, no way to impeach, elect or fire them?

MR. ETRA: Things would be certainly helped a great deal if the rule-making body were more representative. The point is, though, what accountants do will have an effect on the public. What I am asking is to consider that effect. Everyone from Carman Blough to William Casey, in his letter, and including the creation of the FASB last week, everyone has always said that primarily, responsibility has lain with the accountant.

MR. PARKER: For determining accounting principles, not behavioral results!

MR. ETRA: They are inextricably tied together. If you are going to determine principles, the principles will have an effect, and I am asking you to consider the effect. Don't just make the principle without considering what the principle is going to do.

MR. PARKER: I have a question, too, on your common-

sense test when you apply it to pooling. This is as controversial a subject as there can be. There have been pretty good lines of argument advanced on both sides. Yet, you'd rather conclude that one of them does pass the common-sense test and the other one does not. How can you do this so quickly? What tells you that one is "common sense" and one is not?

MR. ETRA: That would have to be my own personal opinion. However, I would subject that opinion to a lay test with that rather simplified example: does ten and ten equal twenty or fifteen?

MR. PARKER: Well this is where I began to get lost, because what does the first "ten" apply to, and what does the other "ten" apply to, and where does the "fifteen" come from? I hear the numbers, but I don't know what they apply to.

MR. ETRA: "Ten" would be the value of the acquired firm's assets; "ten" would also be the...

MR. PARKER: The value measured how?

MR. ETRA: Current value.

MR. PARKER: How measured?

MR. ETRA: Measured? Market value.

MR. PARKER: But no cash ever flowed to reflect that.

MR. ETRA: It's the value of the stock which flows.

MR. PARKER: But who ever paid for it?

MR. ETRA: Excuse me?

MR. PARKER: Who ever paid for it?

MR. ETRA: The acquiring firm!

MR. PARKER: They didn't pay for it; they just issued

the paper stock certificates.

MR. ETRA: Well I think now we are quibbling about terminology and one specific opinion, but I think that the main gist of my argument is that all opinions should be subjected to this test. Perhaps similar dialogues like we are having now would perhaps encourage better opinions.

MR. GELLEIN: Mr. Etra, I've got to return to the matter of motivation, behavior and the like. Up to now we have talked about it in terms of your saying the accountant ought to consider the impact upon behavior. I've got to turn it around. Should accounting objectives be so stated as to reflect the accomplishments of a political, economic or social purpose? And let me be specific without getting completely technical. Let's suppose that a certain accounting method for most corporations would cause income to be reported at a higher level than some other method. Suppose that it should be decided that in order to goose up the economy, it being sort of low now, it would be good to have these companies reporting this higher income because it would have the psychological effect of building up confidence of the people in the state of the economy.

Questions. Should it be an objective of accounting to say that, in those circumstances that method should be adopted which has that result? And, of course, there is the opposite side of it. If you want to dampen things, then you'd go to another accounting method because reported income would be lower.

My question is, "Should this be a part of the objectives of accounting?"

MR. ETRA: No.

MR. GELLEIN: I am glad that's in the record!

CHAIRMAN TRUEBLOOD: Sid?

DEAN DAVIDSON: I wonder if some of the things that you seek aren't already included in what is done and may only require some disaggregation and perhaps some further reporting. With regard to reports of pollution, it is my understanding that the 10-K Form now does require reports of where governmental bodies have proceeded against a firm on environmental questions.

MR. ETRA: Yes, if it's embodied in a lawsuit type of action.

DEAN DAVIDSON: Well, yes. So then, certainly where lawsuit actions or legal proceedings have been instituted those are already included in the 10-K, and I suppose under the new Securities and Exchange Commission rule if it were not included in the financial report, that would have to be disclosed. So, effectively, we are accomplishing that goal.

With regard to the reporting of injuries and deaths and things of that sort, you know determination of causation is not an easy process, and I suppose there is something to be said for waiting until there is legal proof before admitting guilt in such things. If the financial statement were to be disaggregated to have separate volume reporting to the extent of damages or deaths to users of property, would that meet your need, or would you like to go beyond that, to cases not yet

adjudicated?

MR. ETRA: I think there can be several alternate ways of presentation. One might require a corporation to state how many letters of complaint you have received about a specific model car, or how many lawsuits you have incurred because of liability, or how much money has an inadequately tested product caused to be paid out in settlement claims because of the liability of a product. In terms of the information being available, there is a tremendous lack of information, but I think this would force certain companies to come clean. For instance, before deaths occurred on the highway a lot of the major auto companies--and we have verification of these figures--received complaints and were aware of defects in their products and yet were not willing to be honest enough to tell the public, to tell their shareholders and to tell the consumers that these products are causing deaths and severe accidents on the highways.

If you required them to put into their annual reports how many letters of complaint they have received about these cars, I think it would tell the shareholders a lot, tell the consumers a lot, and maybe it would cut down further on highway accidents.

DEAN DAVIDSON: So that in essence you are asking in addition to what we now do, to indicate the number of letters of complaint we received...

MR. ETRA: That would be one alternative.

DEAN DAVIDSON: ...about the problem?

MR. ETRA: Yes.

CHAIRMAN TRUEBLOOD: Time for one more question.

Reed Parker.

MR. PARKER: Just a short one. On page 4 you have indicated you are advocating that management be required to change accounting firms, I think, every four years, is it?

MR. ETRA: Yes.

MR. PARKER: I am not an accountant, so maybe I can ask this question easier. It seems to me if I were the manager of a company and I was quite nefarious, and I looked out at the various accounting firms and said, "Aha--each one of those so-and-so's has got to get a whole new list of clients at the end of every fourth year--boy, am I going to make them compete, to see which one of them will go the farthest to satisfy me and to bend my earnings statements the way I want them. "And I can watch how they work over the four-year period before I have to switch, and find out from my brothers which one of them gives the most, and that's the one I am going to hire!"

Wouldn't this have exactly the opposite...

MR. ETRA: I would hope the American Institute of Certified Public Accountants would have enough safeguards so bending wouldn't be possible.

MR. PARKER: You force them to change every four years.

MR. ETRA: I think this was an extreme type of suggestion. As stated in the suggestion, it would end certain entangling alliances and would have the effect of requiring the accounting firms to ask leading questions, which sometimes,

because accounting firms are the long-term clients of management, they don't ask. Questions such as "Is there really oil in the salad tank," or "What's in your inventory?"

MR. PARKER: Furthermore, I attempted to bring out the fact that if I could change every four years, I could find the one that wouldn't even know where to find the salad-oil tank in four years, whereas, the other one that's been around too long knows better.

MR. ETRA: I would hope the certification of that company would be in question.

DEAN EDWARDS: In the light of your paper and the remarks that you have made, I'd like to ask, whose financial statements are they, in your opinion, and who has the primary responsibility for those statements, and, secondly, what are the practical methods of accounting, if any, in the context of your remarks?

MR. ETRA: I think the liability extends to all those who participate in their preparation--both management and accountants. And I think we will have to wait and see what the Securities and Exchange Commission does in terms of the liability of the attorney who is participating as well. In terms of the parameters, I think that's stated in my statement of objectives of accounting principles, which is that the accounting should provide to the public an understandable presentation of a corporation's financial progress and social impact.

DEAN EDWARDS: In answer to the first question, are

you saying we, you and I, accountants? Do you mean the internal accountant in the firm or do you mean both the internal accountant and the external auditor?

MR. ETRA: Both internal accountant and external auditor. And I do concur with the opinion in the Continental Vending case that accountants should not only be responsible for adhering to generally accepted accounting principles but should be held to a higher standard of fair presentation.

CHAIRMAN TRUEBLOOD: But in order to clarify this for the record even further, Mr. Etra, the initial responsibility for the preparation of the statement would be the internal accountant's responsibility, and then you are adding on to that the participation of the external lawyer, the external accountant, and so forth. That was the thrust of your...

DEAN EDWARDS: That was the thrust of my question.

MR. ETRA: Yes for each stage of its preparation, those who have participated in that stage should be liable, as well as those personnel who find what went on in the other stages should be responsible for those stages as well. I don't think at any stage of the game, one individual, if he does have information about what happened in internal accounting, should be able to disclaim liability.

CHAIRMAN TRUEBLOOD: Thank you very much.

MR. ETRA: Thank you Mr. Chairman.

CHAIRMAN TRUEBLOOD: Very well done. Thank you.

Mr. Walter, of the US Financial Corporation?

MR. R. H. WALTER (US Financial Corporation): Thank you.

CHAIRMAN TRUEBLOOD: Mr. Walter represents a company which is one of the relatively few companies submitting a separate presentation, for which we are quite grateful, and he has come from California to do it.

MR. WALTER: Thank you very much. Well Mr. Chairman and members of the Committee and guests, I appreciate this opportunity but feel somewhat like the fish out of water. But in listening to the immediately prior discussion, I can't start with the basic judgment that all accountants and all businessmen are dishonest. I think we have to start with the basis that all people are fundamentally honest and responsible, and then try to catch the culprits that aren't, but do it on an objective basis and not a subjective basis, if we are all to survive. But in selection of accountants, I enjoyed that little byplay between Dean Edwards and the prior speaker. And I will tell a little joke here if I may. You talk about a board of directors that was picking the accountants, and in general the public accountants are picked not by management but rather by the board, or by the shareholders, or recommended by the board and then selected by the shareholders.

The story goes about the board of directors that was considering a new accounting firm, and they had three firms vying for this position or this task, and they called the first one in and asked them a simple question, "What is two and two?"

He said, "Four."

"Dismissed!"

They called the next one in; the same thing occurred.

The third one came in, and they said, "What is two and two?" and he said, "What did you have in mind?" So, I guess that's where he got the job!

I think we have many things that show that the obligation of management is to all of the shareholders and the investors, whether they be creditor investors or whether they be equity investors. I think the auditor's position, or the certified public accountant's position is to validate that that is the true objective. I think we have to start from a point in order to determine where we will go, and so we state US Financial's position, and it is that it holds the view that the present objectives of financial statements meet the requirements of the various users to whom financial statements are directed.

This view is predicated, however, upon full and fair disclosure--and I really mean full and fair. I mean more disclosure, not less, and perhaps that's by virtue of the detailed footnote to the financial statement, and I would fully subscribe to the fact that if there is a question, then put it in the footnote, and the judgment of the shareholders, investors, will ultimately take care of that.

We do not believe that drastic changes in the accounting rules and methods are dictated, but rather that continuing modifications evolving to meet the changing needs of users of financial statements are what is necessary. It is our belief that all business must operate using forecasts which are the result of business planning. Those forecasts are affirmations

or commitments, if you will, of the managers who forecast. And incidentally, the only forecasts worth a damn are those made by the line managers, not by some statistical branch of the firm so those forecasts are affirmations of the managers who forecast to perform as necessary to meet the business objectives of those forecasts.

Such plans and forecasts must certainly change and constantly change to meet the changing conditions over which a company or its managers have little or no control--and, generally, no control. To supply planning and forecasting data to users of financial statements would, in our opinion, be of little use, and in fact would be self-serving to a point where abuses would occur because of the degree of difference in the manner in which people employ their mental processes in the function of planning. To get right down to the honesty of it, you can then say honesty is a degree thing; morality is a degree thing, or is measured by degrees; ethics are, somewhat, a fixed standard. So maybe what we should have is a statement of the ethics plan that the business wants to follow, and I think that should be management's statement, not that of the certified public accountant.

Our comments at these hearings today are done by outline, which you have before you, and I have tried to categorize the classes or types of users of financial statements who use the statements for decision making. We have the large investor, and he, of course, does a pretty thorough investigation and questions the footnotes and is privileged to ask for

other questions to be answered. We have the small investor, and he is essentially the user who may not understand in detail what all of this is about; certainly, he cannot understand the accounting principles/rules. In fact, we think we do sometimes, but I am not sure that we do always, and I think those small users need to rely on experts for their advice. That could be the broker; the investment banker; it could be some friend who is skilled in the analysis of companies, and so forth. They should not just accept the word of mouth, unless they believe in the person giving the advice.

So I raise the question, "Is that small investor capable of understanding all of these things that we talk about and the rules that we have to meet?" And, if you want some real fun, then try to figure out the amount of tax you are supposed to estimate and what you are supposed to pay and the manner in which you are supposed to do it. That's a manual, written like a dictionary, and you can find every kind of meaning in it you want to look for.

We have the banking and lending institutions, and I really believe they should make their own credit calls, their own analyses and make their commitments based on their own research, not special reports made by certified public accountants. I think it's management's job to provide them with the necessary data that they need and validate that data if they are to become a creditor, and I would shudder to think that a lender would say "I make this loan because of your auditor's certification."

The institutional investor's needs are for a longer

period of time; generally, he is the funded-debt type of lender, or the debt with an equity consideration or kicker on it. He has a different criterion. He must meet the management, he must be very familiar with the day-to-day operations and the decision making process of that management.

And, underwriters who go to the public, both for equity sale and for private placement of funded debt or convertibles privately placed, must review management's objectives, their controls and their past performance. They must also look at the internal forecasting processes of managements and see how closely they come to meeting their objectives or their goals. He must satisfy himself as to the need for that equity which is being sold or for the debt placement.

Now the underwriting fee is directly related to the risk that is inherent in making the offering to the public. He is charging for it. Let the underwriter put it on the line. And, if he doesn't believe in it, then he should not bring it to the public.

We have the analysts, which is the sixth class. There are different kinds of analysts, and they have different kinds of needs. We have the independent analyst who needs to be pretty careful because he sells his professional output to others upon which they base their investment decision. We have the captive analyst who is captive to the brokerage house. And on that one, I think anybody that accepts his recommendation has to ask a further question, "How many shares of stock does this firm have, how much short are they in the stock,

what is their position, are they facing another underwriting at a point downstream for the client whose stock they are recommending?" I think that's the one where you have to raise the question, and I think that is not up to the accountant or even management to make that decision.

And then you have the institutional investor, and that is an in-house type of analysis which has to be based on their own investigation.

Now in conclusion, on this phase, then, I think the present form and content of financial statements adequately serves each type of user's needs as a bona fide point of departure for his own research. It appears to us to be inadvisable to supply data that each user of financial statements needs for his own particular requirements. There appears to be no good reason that data should be supplied voluntarily by professionals beyond the present requirements. In other words, I do not want accountants validating management's forecasts unless they are prepared to get on the hook and say, "Yes, we agree with these assumptions and that, if you follow these assumptions and you do what you forecast, then we will treat in historical accounting the matters or the transactions in their booking of profit and their effect on financial statements of that company in the manner in which they were forecast." In that case, we are going to start five-year forecasts tomorrow because we want to see the people committed. If there is such a commitment, then management can meet the schedule because they know by what rules they play. If there is no such commit-

ment that the assumptions are valid and will be followed, notwithstanding subsequent rule-change, then let's not have the forecasts.

Now there appears to be no good reason that data should be supplied voluntarily by professionals beyond present requirements. This could create a further legal liability. Each user of a financial statement should seek and obtain, if possible, his own additional data as necessary to meet his particular degree of risk inherent to the class of investment which he will make. I think the real estate industry is one that is particularly vulnerable to a lack of standards. Why? Because it's an individual entrepreneur type of business where individual creation, innovativeness, innovation, if you will, of the kinds of transactions they get into creates the problem. Let's talk about the dimensions of that.

The real estate industry is one deserving some consideration as to some kinds of standards and rules fitting particularly to it. If you consider that the construction industry in the United States is equal to about 10% of the gross national product, and about half of that is in the shelter part, or the housing part that I am primarily concerned with, then you have 5% or fifty billion dollars as the share of the gross national product per annum. Currently the industry is fragmented and this is the very reason that it needs lots of help. The top three producers, last year--1971 calendar year, that is--would have produced about a 2 to 2½% share of market of the fifty-billion market. The auto industry, on the other hand,

has General Motors with about 55% of that market. General Motors, Ford and Chrysler have more than 80%.

It is possible, in our belief, that over the next five years, that a firm committed to the shelter industry or the production of housing and its related needs, that relate to the housing and filling of people's need for living, will probably hit a 5% share of market. That requires a very major task of raising a lot of money. That 5% share of market related to today's economic norms, assuming no further inflation, would mean two and a half billion dollars of volume; it would mean that it would require the raising of over two hundred and fifty million dollars per month by one firm for permanent financing of the users of their product--housing.

In order to do this job, it is vital that credibility be brought to our industry because it is only through the confidence of the investor that we can adequately raise or approach the raising of the kind of money that is needed. I do not believe that government can continue to underwrite and have special programs and do all of the other things that it's doing and still support housing to the extent that it has. I believe that it's a challenge to the private sector to continue to stress the raising of more of its own money, which is the key commodity in housing. In order to do that, we must have rules and we must have the proper supporting of the accounting profession to lend credibility to our firms' activities if we are to have the investor confidence to raise that money.

I want to come back to the forecasting process. It

requires constant updating and it is a perpetual process. I don't think it's something you do by quarters; I think it's something that you amend, day to day, if you are operating properly. I think that forecasts are best used by senior management to measure the timeliness and degree of performance of subordinates. And again, I think that the total use by the investors vary so widely that it is impossible in one set of financial statements to provide everything necessary to all people; you can't be all things to all people.

I think that the publishing of forecasts which could go off appreciably by influences beyond the control of management could eventually create disenchantment, thereby eroding considerably the investor confidence and faith in business. I think publication of an official forecast could reveal corporate strategy to competitors. And you may say, "Well, it's right socially that you should tell everybody else what you are doing." But I think if somebody has authored or innovated a new plan or approach to an industry or new product they should be privileged to enjoy the fruits of their innovativeness.

Now I think if these kinds of forecasts are required, then the disclaimer would be so extensive to protect from legal liability both management, corporate board and certified public accountants, that they would have little value. It would force management to estimate on a conservative basis. If you wanted to be unscrupulous and you had a new company which was a romance stock, let's call it, I suppose you might make a bullish forecast and thereby profit, and thereby undo or outcompete

your competitors because you'd have more and cheaper money.

I think history is the stuff business is made of; it's the curve of performance of management. And if you stay at it long enough, the public will respect that and will reward you accordingly, based upon historical performance.

Now some general criticisms or suggestions. I have always searched and have had great fun with this, as Messrs. Edwards, Gellein and Trueblood know. I always say, "Define 'generally accepted accounting principles'."

CHAIRMAN TRUEBLOOD: We thought Frank took care of you, on that!

MR. WALTER: Well he did, almost. It is an opinion. And then we get down to the next thing, where you say in your covering letter, "In our opinion, this fairly presents the position of the company." Well, why don't we add one more thing and say, "In our opinion, under the present management..." and then why not state that management, "We have viewed management's business plans and considering the external environmental changes and external influences, they have done well in the performance of their business plans," again, "in our opinion."

I think the footnotes for financial statements should not be just cold, canned, after-the-fact conclusions because they often create more questions than they answer. So why not have footnotes state what the managers' business reasons were for that judgment on that particular deal that you are going into in the footnote?

You say, "Well, that's glossing the lily." Well

fine--why cut the lily off at the stem? Let it bloom and state why it was, and state that it was the objective and whether it has occurred.

Now I'd like to talk a little bit about the Accounting Principles Board Rules. There is nobody who could make a rule which would be totally adequate, over-all. And I know that some of you gentlemen here at the head table are on that Board, and we respect you. But there is no way that the single rule can be universal in its application to all types and kinds of businesses. And if you don't believe it, let's take APB 15. All right, we run a real estate investment trust, which is a short term mortgage lending trust. So here comes APB 15. For our original issue sixty-some million dollars was paid to us on June twenty ninth. It was based on a share of common stock and a share of warrant, or a warrant for a common share, as a unit. Well, under the rules, on a straight-debt indication, our earnings were a dollar and a half; but, under the rules, it would meana seventy-five cents, because of the cut in the issue price caused by the warrants. And, now, that's being amended.

We passed a rule, as a board of trustees, that we would pay out 100% of the earnings thereby obviating the problem of the dilution by the warrant. How can there be dilution when the primary shareholder has received the benefit of all or 100% of the earnings of that trust?

So now we come up with a two class system in an attempt to modify that rule. I submit that the rule was never intended to apply to an R-E-I-T, and I think some of the rules should be classified as to what industries or what kinds of business

they do apply. Sixteen was commented on at prior meetings, and I won't comment on that. I think that we lost something in business when we literally were forced to issue only one class of common stock for a pooling-of-interest kind of merger. I would submit, there could only be one real reason for a merger and that's not profit or assets perhaps, but rather the management of the company being acquired. Now it could be an assets play, and there may be a case where management had adequate capability to employ those assets for profit for shareholders. I think that, on Eighteen, that's one of my methods, because, under the equity, one-line method of reporting revenues from joint ventures--I'd like to take the extremely ridiculous case and say that I form a corporation, and I enter only joint ventures; therefore, my P&L would have a one-line entry, "Net profit," or "Net earnings from joint ventures."

We went to the Securities and Exchange Commission a year and a half ago because we were involved substantially in joint ventures. We asked that we be permitted to include our share of revenues from joint ventures in our reserves reported to shareholders, the reason being that we operate on our own and we also operate through joint ventures. And our net, bottom-line percentage of profits as related to gross revenues jumped all over the place, depending upon whether the income was on one line, from joint ventures, or wasn't stated.

The Securities and Exchange Commission agreed that we more adequately disclosed to the shareholders if we picked up our shares of revenues. So notwithstanding APB Eighteen, we

have followed that practice, under special sanction from the Securities and Exchange Commission.

Again, we say that the real estate industry has great needs. The reason, again, is the uniqueness because of the variety of transactions. They are not just manufacturing widgets; they are doing many things and each deal varies. The problem really is when to recognize or realize the income; because of the great variety of transactions, it becomes extremely difficult. I wish that we could find rules wherein we would recognize profit when the economic risk truly passes. Or where we have "multi" kinds of transactions that we could do it as suggested under your forerunner draft of the land development opinion. When an activity is completed, then why should we not recognize the profit? If you are going to balance the revenues and costs and the related income or losses therefrom, then it would seem fair, to me, to recognize profits at the point of completion of an activity. That can cause lots of complication on "What is cost, where are you going to put it." But, assuming it's an honest, forthright approach to it, the deferment of costs is operationally bad, in our opinion, because managers tend to lose track of what these deferments of costs or deferred costs are, and it quite often can lead to confusion. So, we much prefer that all costs be written off directly.

The allocation of deferred costs to future transactions or future profit reporting is mechanically difficult. I think there are tremendous challenges, and I think that we

have to determine "When does form precede or superimpose itself over substance, and when does substance overtake form," and I say that there are times when you have a legally binding business judgment that should precede the old saw of substance that the accountants use, and I wish we could find a new term for that.

I would like to close this part of my presentation by reading a quotation from Herman Bevis' Corporate Financial Reporting in a Competitive Economy.

The growth of the large corporation, however, has been accompanied by the development of a remarkable system of accounting and accountability. Its apparent objective has been to measure profitability and to indicate performance, efficiency, and growth. It is not at all farfetched to add that simultaneously we have been developing a powerful instrument of discipline, not only for the modern corporation, but for large segments of Western society as well. For when a man is obliged to make financial accountings of his activities, the discipline becomes more or less a part of his character and imposes on him much higher ethical standards measured in terms of social responsibility than if there were no reckoning. The highest ethical attainment is reached when a man accepts this accountability as a challenge to measure himself by his willingness to report fully on the results of his own actions. Looked at in this way, a practical observer of the corporate scene can agree with the academicians that the accounting discipline works hand in hand with rising ethical standards of the society.

CHAIRMAN TRUEBLOOD: Thank you very much, Bob. Now let me start out with this kind of question, and I think it follows upon where you left off. When we are talking "objectives," we hope to be able to maintain our position that these objectives should be overriding for the entire business community. But the question I wanted to ask you is this--am I correct in assuming that, in relation to your concern about the real

estate industry, or any other particular industry, where you talk about particular applications or unusual situations, that you are really talking about rules and procedures which might nonetheless fit into overriding objectives, or are you, rather, saying that there must be a different set of objectives by industry?

Do I make the question so complicated, you don't understand me?

MR. WALTER: Yes, I think there are a set of rules in financial reporting which can be overriding, but then I think there are special cases, such as my REIT example of APB Fifteen, which needs to be modified or appended to cover a specific industry, as the exception, and I believe that those rules should be modified for that particular business or industry when it occurs that there is a lacking in the overriding rule.

CHAIRMAN TRUEBLOOD: Well I thought that's what you were saying.

MR. WALTER: Yes.

CHAIRMAN TRUEBLOOD: And you aren't the only witness who is going to take that position. It's a quite valid position that we obviously may not have recognized enough in the past. I just wanted to be sure I had a clear understanding about the level of your intention.

One other question. Back in the early part of your presentation, you talk about the different needs of the different users, of five or six of them...

MR. WALTER: Yes.

CHAIRMAN TRUEBLOOD: ...of which I, at least personally, completely concur. The problem I have, however, is this overriding and increasing legal concern or legal problem of "information to one should be information to all." For example, to pick up your example of the banker who needs a certain kind of thing that maybe the small investor does not need, the problem is--and, maybe Dave should comment on this--even though the small investor doesn't need it, is he not entitled to it? This kind of relates to Mr. Etra's presentation, too.

MR. WALTER: Yes, I think he is entitled to it. The small shareholder, first of all, generally is not competent to interpret. It's not my position to judge that, but I think you would concede that point. The tendency would be in the case of forecasting, to place a blind faith in that, and thereby not ask the appropriate questions on the basis for the forecast. If he places blind faith in it, he would be hurt. So here, we are trying to protect...

CHAIRMAN TRUEBLOOD: Conceptually, you would take the position that if, indeed, he did want it or had the foresight to ask for it, you would give it to him, as well as to the banker or analyst?

MR. WALTER: Yes, and I would go one step further. I would have every analyst, whether he be one of the three types of analysts that I alluded to or whether he would be another type of analyst, whenever he puts out a report to a given kind of client, also file that report with the Securities and

Exchange Commission and that it be filed under the name of the company that it covers. And that way, the small shareholder would likewise have that information available, if he so chose, or he elects to get it.

CHAIRMAN TRUEBLOOD: In the same manner that one issues an opinion, it goes to anybody asking for it?

MR. WALTER: That's right.

CHAIRMAN TRUEBLOOD: How about the rest of the panel? Do you have anything, Reed and Oscar?

MR. GELLEIN: Yes, just one question, Bob. When you classified the users of financial statements, I notice you have put in parenthesis over on Page Two, "for decisions." Are you implying there are other users you acknowledge as having, let's say, a right to the information? See, that goes back to the first sentence...

MR. WALTER: Right.

MR. GELLEIN: ...which says that the overriding objective should lead to the requirements of the various users to whom the financial statements are directed.

MR. WALTER: That's right.

MR. GELLEIN: My question is really this--are these the users, as you see it, to whom they are directed, the ones listed beginning on Page Two?

MR. WALTER: Yes they are, and I think that I could include in these six categories predominantly all the users. Now there might be other users. I am not trying to eliminate any, Mr. Gellein, but rather, state the difference in the needs

of given users.

CHAIRMAN TRUEBLOOD: I think these six would fit the classification we have come up with empirically, pretty well. Sid, you had a question?

DEAN DAVIDSON: Not so much a question as a matter of clarification. Did I understand you to say, in the early part of your presentation, that if accountants would agree not to change the rules of the game during the period of the forecast, that you would be in favor of forecasts?

MR. WALTER: Well...

DEAN DAVIDSON: I wasn't sure.

MR. WALTER: I am not in favor of giving forecasts to the public because of the great number of economic influences and other influences that are government actions, for instance, that are beyond management's capability of comprehending before they happen, and therefore, forecasts must change. I object to making forecasts public.

DEAN DAVIDSON: I guess I did misunderstand you, because I thought...

MR. WALTER: Yes?

DEAN DAVIDSON: ...you said...

MR. WALTER: I said...

DEAN DAVIDSON: ...as long as the accountants didn't change the ways of compiling the data...

MR. WALTER: I think it's a case of goal or objective-setting by management. If we build a plan of action and we make it public, all I am saying is that if there are to be

forecasts, then let's state the rules of the forecasting and let's live by those rules so that management can perform within the parameters of those rules, under known conditions, or a known set of standards because if you change the standards then everybody is in trouble because you create a very massive lack of credibility, which is so vital.

DEAN DAVIDSON: Yes. But, are these accountants' standards or standards of the government, with regard to the setting of prices and things of that sort? That's what I wasn't clear about. Accountants have some control over the standards they use, but our influence with regard to setting national economic policy probably isn't all that great.

MR. WALTER: Well the accountants have control over their standards through the audit procedures and through the APB's in the past. Let's concede that. But, let's also concede that there should be adequate time before the effect of a rule-change and that that rule-change should probably not be on January 1, 1972, or June 30, 1972, but should be on the next, the subsequent fiscal year of the company to which the rule applies, provided that there is adequate lead time for management to change the input and its business plans, because I think it's unfair to change the rules after the fact.

DEAN DAVIDSON: But, under those circumstances you would be in favor of publishing forecasts?

MR. WALTER: I am never in favor of publishing forecasts. I am saying, if we have to have a rule, if we have to publish forecasts, then let's define the rules that we are

going to live by.

DEAN DAVIDSON: Ah-ha.

CHAIRMAN TRUEBLOOD: If I understand what Bob is saying, if we are going to have forecasts, then we must have stability of rules so that the businessman can plan his business transactions, in order to know how they are going to be reflected in the statement...

MR. WALTER: That's right.

CHAIRMAN TRUEBLOOD: ...before he consummates his transactions. Isn't that your...

MR. WALTER: The statement is only the record of performance of management, against business planning.

CHAIRMAN TRUEBLOOD: Anything further from the panel-- Frank Weston?

MR. WESTON: Judging from the comment at the top of Page Three, you may be the only participant here to say the present form and content of the statements are adequate; would you then urge us to state objectives in terms of present practice, specifically?

MR. WALTER: I would start with present practice, as my point of departure, and would not make drastic changes but would rather, evolve the rules.

MR. WESTON: What area, in what direction would you urge us to lead the development of the rule making?

MR. WALTER: I would increase the disclosure and footnotes. But, in increasing the amount of disclosure and footnotes, I would want to have the business reasons for a

particular dealing so that some objective standard is placed upon the rule as well as a specific statement of the rules.

MR. WESTON: But, to jump to a rather topical item, what would your view be on reflecting more current values in financial statements, as an objective?

MR. WALTER: Well of course, in some industries, such as the insurance industry, we can take current market value of securities.

MR. WESTON: I think of real estate and oil and gas, to take two other examples.

MR. WALTER: I like the cost method because it eliminates the problem of going to get an appraisal. An appraisal is kind of like generally accepted accounting principles; it's an opinion of value. But, if I am going to build a financial statement on an opinion of value, then that's different than my cost value.

MR. WESTON: But isn't that opinion of current value more helpful to investors than 1922 costs in terms of the objectives and usefulness of the data?

MR. WALTER: If you want to include an opinion of current value in a footnote, then by all means, I would do it, and I would articulate that it's based on a qualified appraisal of "X..."

But I would not do it in a financial statement. If you have that kind of a company--everything at 1922 costs--then you have several solutions. They can sell their company by the purchase method...

MR. WESTON: Not many around like that, though!

MR. WALTER: I would like to find a few.

CHAIRMAN TRUEBLOOD: Let me expand upon Frank's question and ask for a clarification on your answer about fair values. You have made the statement, in relation to other circumstances that you feel the answer is frequently "further disclosure," by way of footnotes...

MR. WALTER: Right.

CHAIRMAN TRUEBLOOD: ...and yet we have been exhorted here today by others that we should, as an objective, have in mind the simplification and clarification of financial presentations. Now it seems to me, Bob, that it's really only the quite sophisticated user who can convert a footnote into the effect it would have on the financial statement. You can-- Frank, and others here. Let's leave Aunt Jane out of it; let's go to some of the institutional investors. Should they have the burden of taking footnote data and convert it into the table?

MR. WALTER: I think if they are astute investors, they will do exactly that and they will question management and they will look at the book value. I think that's our obligation, to make an investment decision that's proper. And I would say that if you are ever going to come to current market value in statements, then they should be done on a pro forma basis showing the related cost base in a parallel column.

CHAIRMAN TRUEBLOOD: I think that's a commonly held view, based on the inputs to this time.

MR. WALTER: Right.

CHAIRMAN TRUEBLOOD: It may be an open position as to whether the supplemental data should be attested, but that's another question. Anything else from the panel on Mr. Walter's presentation?

(No responses)

CHAIRMAN TRUEBLOOD: Thank you, sir, very much. Thank you, too, for making the trip, and I appreciate it a great deal.

Ernst & Ernst?

MR. RICHARD T. BAKER (Ernst & Ernst): Good afternoon. I believe we are the last ones on your program for today. Perhaps you have saved the tough ones for us. First of all, I am Dick Baker, Manager Partner of Ernst & Ernst, and on my right, we have Bob Mautz, and next to me we have Ray Groves, who are both partners in our firm.

Our purpose in requesting permission to appear before you, Mr. Chairman, is twofold. First, we wish to express our concern on a number of points related directly to the charge of your Study Group, and second, we will urge the desirability of further efforts of the same type.

As you know, we presented our views on the objectives of accounting to your Study Group last January. Those views were influenced by an extensive survey of the thoughts and experiences of executives within our firm and by the reported results of their unsolicited discussions with clients, company representatives, bankers, analysts, brokers, educators and

others. We distributed our statement widely among friends and clients and have had a number of responses. In addition, we read many of the statements of others who have expressed their views to you.

As we discussed these various ideas, we concluded that our January statement might have been too brief and that we had additional ideas deserving of your consideration. For this reason we have prepared a second paper, which you also have. In preparing this second paper, we have obtained a greater appreciation of the difficulty of your assignment and of the problems which you and your Group face in trying to develop a statement of objectives.

One of our concerns has to do with the manner of stating the objectives of financial statements and of accounting. Broadly stated objectives may be indispensable by themselves, but this is not enough; the ultimate purpose of a statement of objectives must be to influence practice. Until the impact of an objective on practice is clearly established, its effectiveness as an objective is not known. If the objectives are to be meaningful to the accounting profession and to others, if they are to provide a guide to us in our practice, they must be enunciated in such a way that their method of implementation is unambiguous. Unspecific objectives, subject to varying interpretations, may be divisive rather than unifying. The accounting profession, as you know, needs all the unification it can get.

We hope that whatever report the Study Group renders

will explain the implementation of the proposed objectives sufficiently so that different readers will not read substantially different possibilities into them. We view change as desirable and progress as essential, but the two should not be confused. Unless change is in the right direction, it is antiprogressive. Some statements have been made to your Group advocating changes which have not yet been tested sufficiently to warrant any indication of approval whatever, either for the immediate future or for the long range. As proposals, they remain legitimate subjects of interest and candidates for research attention, but one makes a mistake to urge them as objectives.

A second concern, therefore, is that the natural desire to be forward looking may lead the Study Group to advocate fundamental changes in accounting, if not now, then at least in the long run. Significant changes for which there is not at this time any substantial body of evidence to show that they are wanted by the majority of those concerned with financial statements, and that on a cost-benefit basis are not useful, or that may not even be generally possible, should not be included as objectives.

In the light of the quality of the Study Group and its staff, our fears may well be unfounded, but we reaffirm our expectations that any objectives calling for fundamental changes will be supported by persuasive evidence of demand, of need and of feasibility.

We may not have seen all the statements submitted to

the Study Group, but those we have seen give less attention to the interest and point of view of corporate management than we believe is desirable. We recognize that, in specific cases, individual corporate managements have taken advantage of the excessive permissiveness now present in generally accepted accounting principles. On the other hand, we have faith in the honor and integrity of the great majority of corporate executives. We have no reason to think that they will favor weak or other unsatisfactory accounting principles which can be utilized to the advantage of the unscrupulous, and thus work to the disadvantage of the honest majority.

In our view, it is imperative that corporate management's interests and experience be included in stating the objectives of financial statements as well as in the formulation and implementation of accounting principles. No other group has the intimate knowledge of business problems, the understanding of competitive pressures or the awareness of the effect of circumstances on the application of accounting principles. No group has a greater interest in full and fair presentation.

The suggestion that accountants, regulators and financial statement users should establish accounting principles independently of the management which is then expected to apply them is unsound and unworkable. The written representations to the Study Group which we had read lean strongly toward change; perhaps this is to be expected. Those who want something changed spend the energy and take the time to make their wants known; those who find the status quo satisfactory

are less inclined to express their views. So one should not be surprised to find a preponderance of views in favor of change--some of it, extreme change.

We find, in these papers, very little attempt to describe the advantages or consider adequately the virtues of what is now accepted practice. The advantages of conventional accounting and the difficulties of actually implementing the recommended alternatives are given little attention. The advantages of the alternate methods and the criticisms of conventional accounting, on the other hand, have been emphasized out of all proportion.

We trust that, in reaching its conclusions, the Study Group will balance the evidence for and against some of these issues more realistically than do the papers submitted to the Study Group.

A final concern relates to the enthusiasm with which the report of the Wheat Committee was received. The Wheat Committee report compared the work of your Study Group with that of a constitutional convention supplying, and I quote, "a chart of objectives and basic concepts which will enable the day-to-day work of the Board to be more firmly grounded than before."

If the recommendations of your Study Group are accepted with the same uncritical eagerness as were the Wheat proposals, you are not only the innovators of your proposals but also the court of last resort, which is a very heavy responsibility. Our second position paper offers a proposal for

a continuation of the very kind of work in which you have been and are now engaged. We think delineation of the objectives of financial statements is a problem of such importance to so many interests that it should be carried on. We do not see this recommendation as either critical of or conflicting seriously with the work of your Study Group. The emergency which some considered to exist at the time of your appointment has at least partially been met by the Council's actions with respect to the Wheat Committee recommendations. If your Study Group enunciates a clear set of objectives for financial statements, to serve as a guide to the proposed Financial Accounting Standards Board, the apparent crisis will appear to have been passed. But our profession should do more than meet crises. We ought to look ahead.

The financial market is changing and will continue to change. A broader variety of interests than is represented by your Study Group will make its wants, needs, suspicions and fears known. The view from any single vantage point may be a distorted one. We need to bring the full range of interest in financial statements together for a thorough examination of the uses of financial statements and of the relative rights and responsibilities of preparers and reviewers and users. Therefore, we recommend the creation of a continuing conference on accounting objectives, to be established at a high level and with a broad base of representation so that all the interests in corporate financial reporting are assured a voice. Such a conference, with more time at its disposal and a broader charge

than that given to your Study Group, could direct its attention to resolving a variety of issues related to financial reporting, although not directly involved in financial statement presentation.

It would appear fitting if your Study Group, having completed its assigned task, would include a recommendation for the establishment of a continuing study of this nature.

Let me add one other concern that we share with others, and I say this in a completely friendly and forthright manner. A document entitled "Information for Proprietors and Others," treating a topic similar to the assignment of your Study Group, was published earlier this year. Among its five authors are listed the Chairman of this Study Group and two of the staff members. The paper arrives at what appeared to be definite conclusions, including the following, and I quote:

If the core statement-satellite report expects to be developed to its fullest, the profession must move toward economic or fair market values, away from historical cost.

The paper is described as "prepared for the Tenth International Congress of Accountants which will be held in October, 1972."

Recent public statements by yourself, Mr. Chairman, state that no conclusions have yet been reached and that essential research is still in progress. If one or more members of the Study Group has already established a position on the objectives of financial statements which will be reaffirmed in

October, 1972, it would seem desirable that there be some explanation of the relationship between "Information for Proprietors and Others" and the assignment of this Study Group.

Thank you.

CHAIRMAN TRUEBLOOD: Thank you, Dick, very much for another of your superb presentations. I should be remiss if I did not thank you publicly for the extensive, almost full time, very good work of your man, Mr. Streit, who has been given to us, really, to proceed with our work. I make only one point of clarification. The document you are talking about was written before this Group was organized. It happens to feature some of the things we are talking about, and I am sure that there is no predisposition with those conclusions and that my personal assurances will be accepted by the group.

MR. BAKER: Bob, I am delighted you have made this explanation. We have encountered it several times and I understand it, then.

CHAIRMAN TRUEBLOOD: The paper was prepared for the Sydney International Congress, and I think it was submitted in the fall of 1970, something like that, or 1971, before we were established.

MR. BAKER: Great, great.

CHAIRMAN TRUEBLOOD: So be it. Now I would like to start out with the idea of a continuing conference on accounting objectives, which I think to be excellent; I think it to be necessary. I am now speaking my personal point of view. We have not come to any conclusions in this Group, and it is

not on the agenda, but I note, Oscar, that that fits very closely your suggestion to the Wheat Committee where you suggest an ongoing group to talk about objectives in relation to whatever evolved from the Wheat Committee.

MR. GELLEIN: I guess we thought about every five years was often enough.

CHAIRMAN TRUEBLOOD: Would you care to comment on that?

MR. GELLEIN: No. I will just say that we thought about every five years you ought to do it. The environment around us changes fast enough that you ought to take a look at it then.

MR. BAKER: Oscar, if you don't have it scheduled, instead of five years going by, fifteen go by.

MR. GELLEIN: Dick, I take it you are concerned about what our report might say. I think the message comes through pretty clear to us. So let me start there. I guess your concerns relate to several factors. One, that it would create additional divisiveness, as I understand it. The other one is that it will deter us from the consideration of the immediate problems.

Now let me speak to that, and ask a question on that last point. I see you take a pretty dim view of current-value accounting in this paper. You say you've got to go into forecasting cautiously. I am not arguing these points--I am just stating them: human resource accounting, be very cautious, and so forth, on down the line.

My question is, what are the immediate problems, in your judgment, that need attention, that we as an objective group can deal with?

MR. BAKER: Well, Oscar, I'd say first of all, the unfinished business that the Accounting Principles Board has is closely related. I think much of that needs to be got on with and I don't think we want our firm misunderstood on this. We think there are many things that need to be done and I think the idea of having delineated objectives is an excellent idea. I think it's tough to do it without having some implementation measures ready to make sure that we all are on the same side of the street on it. I think in our fuller paper we bring out some further things that we think need to be studied. I could just for a minute fill in the gap--you know, companies work very carefully in preparing the financial statements, and then they have an accountant certify to them, and the responsibility assumed by both the company and the accountant is very, very serious. It grows from this and I am trying to establish the chain to the investor here. Other people work on this, including people such as Reed Parker, and they do a great job. But as it filters down to where an investment decision is made, this may involve a considerable number of people with various degrees of skill, and there is no responsibility that falls along with this advice as to what is a good investment and what the stock is going to do. There is no penalty for anyone saying that such-and-such stock will make thirty dollars a share next year, or five dollars a share, or they will lose

money. And I think that we would plead that there should be a little better coordination of what the responsibilities of all the people involved in getting from the company to the final investor are, that these get enunciated and that the responsibilities be very clearly stated.

I think our paper, Oscar, goes into that, to some extent.

DEAN DAVIDSON: Dick, as you spoke, I thought I heard you say that one of your concerns was that the views and interests of corporate management were not given, or might not be given sufficient attention in the report. But in setting out the objectives of accounting and without meaning to denigrate or belittle the importance of the views and interests of corporate management, do you feel that the broad social interests, the broad public interests should take precedence over the interests of corporate management? Let me give you an illustration.

In talking about the forecasting question, several of the speakers this morning and this afternoon have made the point that forecasts might somehow destroy the competitive advantage that a firm holds. Well if it were felt that the publication of forecasts might somehow lead to a better allocation of resources even though it tended to weaken a special market position, then the question is, "Should this Group in seeking objectives urge the publication of forecasts in this broader social interest or should we be interested in preserving the special position of corporate management?"

MR. BAKER: Well Sid, I'd say this is an area that I think needs a great deal of study and I think not only do we need the voices of professional accountants and financial analysts and economists and others, I think we need to hear, in great, great detail, the other voices such as management and such as the various people from the public. And I think whenever we try to arrive at a final decision as to whether forecasting information is good or bad, or whether you separate it from feasibility studies, whether it's the same thing or not, there's a lot of questions that need to be resolved.

As an example, our firm is presently engaged in making a study as to what we feel should be done on forecasting and we plan to make that public when we get finished with it. But we find, right now, that we have a great deal of different voices within our own organization as to, first of all, whether there should be forecast information and secondly, who should do it and what role the outside accountant should play in this. It's real tough, Sid.

DEAN DAVIDSON: I agree. I don't think the returns are all in yet, by a long way, and there is much study that has to be done but I think there does remain the question of what should be the source of the overriding motion that would control this Group, in suggesting objectives, whether it should be the broad public interest or whether it should be something else.

MR. BAKER: Well, Sid, there is...

MR. PARKER: To amplify Sidney's question concerning

whether the management has it and the public doesn't. As it stands now, the management has it. Some of it gets to the press; the financial analysts can get some more pieces of it. So that to the extent we don't have formal forecasting, or some way to do it, we leave some extra advantage with the sophisticated financial analysts, as compared to other groups, and that is still another part of the problem.

MR. BAKER: Reed, I appreciate that. One of my associates, here, I think would like to be heard on that. This is Bob Mautz.

MR. ROBERT K. MAUTZ (Ernst & Ernst): Sidney, we don't want to be aligned against social interests, obviously, but I don't think it's all that clear. One possibility in the publication of forecasts is that management will become so intent on making the forecast and coming as close as it can to the forecast that total productivity will be lessened. It's a very real possibility and one we hope you will take into account when you decide this important matter.

CHAIRMAN TRUEBLOOD: You should know, as I imagine you do, although someone in the audience might not, that FEI has also contracted for a major work on forecasting with Carnegie-Mellon University, I believe. I have four questions lined up for the panel but may I use the prerogatives of the Chair and ask you one of my own, first? I am intrigued with this continuing-concerns idea. And I am wondering to what extent that part of the Wheat proposal, which sets up an advisory board--I believe the rule is--well the suggestion is,

of about twenty, I believe...

MR. BAKER: Right.

CHAIRMAN TRUEBLOOD: I believe with the proposed rule that no more than 25% of that number can be from any one segment of the economy.

MR. BAKER. Yes.

CHAIRMAN TRUEBLOOD: Now to what extent, Dick, does that help you in your concern which you have expressed many times about representative representation across the business and economic community?

MR. BAKER: Well your suggestion, Bob, that this Group might take into consideration objectives...

CHAIRMAN TRUEBLOOD: I am asking to what extent does that alleviate your concern, not to the exclusion of a continuing conference.

MR. BAKER: Not too much, basically. I think they are going to have their hands full if they fulfill the role that's been...

CHAIRMAN TRUEBLOOD: With the day-to-day stuff?

MR. BAKER: Right.

CHAIRMAN TRUEBLOOD: So you are asking for a thinking, conceptual, philosophical group, such as we hope we are...

MR. BAKER: Right.

CHAIRMAN TRUEBLOOD: ...on a continuing basis.

MR. BAKER: Right. Bob, along that line, we want a much broader group than as was represented on your Group.

CHAIRMAN TRUEBLOOD: But you do not know, yet, how

broad the advisory group is going to be, do you?

MR. BAKER: The financial...

CHAIRMAN TRUEBLOOD: No--the advisory council.

MR. BAKER: They said, "approximately twenty," and said "no more than a fourth from any one section."

CHAIRMAN TRUEBLOOD: So you are thinking "bigger and broader."

MR. BAKER: Well not necessarily bigger, I don't think you necessarily need four or five from the same discipline. Perhaps it could be a group of twenty on up.

CHAIRMAN TRUEBLOOD: But with a significant diversification of interests in the sense of discipline and activities?

MR. BAKER: Very much so, yes sir.

CHAIRMAN TRUEBLOOD: Five would be too many from a practicing profession.

MR. BAKER: I think so.

CHAIRMAN TRUEBLOOD: Okay. Oscar?

MR. GELLEIN: I was just wondering if my inference is correct, from Page 3 the last paragraph. We have heard and read a lot about the question of valid rights and information and who has an appropriate interest in the financial statements of the company and the like, and I see here that you indicate that in your view it is the existing shareholder that has the primary interest. I don't want to broaden that out to all possibilities but let's think of the potential buying investor and let's compare the existing shareholder with the potential shareholder. When a company lists its stock on the

exchange, it makes it available to the public for good reason, to create a market for its shares, creating an opportunity to add to its capital from time to time. Now the existing shareholder's decision with respect to a share of stock is "hold" or "sell." The potential buyer's in that market decision is "reject" or "buy." Now, my question is, do you view the "hold or sell" decision as being more important than the "reject or buy" decision in terms of stating objectives of financial statements and uses and needs?

MR. MAUTZ: Well, Oscar, I don't think it's a question of which of those decisions is more difficult and more vital; I think it's a question of the fact that democracy says the man who has an interest has a vote, and the man who doesn't have an interest doesn't get a vote. We don't let people who are not citizens of the country vote in our elections; they don't have that kind of an interest. The man who already has a commitment to that company is in a different position to the untold numbers of people who may have an interest some day but don't now.

MR. GELLEIN: This becomes awfully important now, because it gets into the question of how much conservatism do you have in financial statements, and this then helps you decide that question, you see--and before you can decide the question of how much conservatism, it seems to me you have to answer this question and it may lead to that determination.

MR. RAYMOND GROVES (Ernst & Ernst): I don't follow how the answer to the first question leads to the answer of

how much conservatism.

MR. GELLEIN: Well if you have to pit the interest of one against the other in making all the estimates going into the determination of financial statements, and we have those areas where judgments and estimates have to be made, they can be made within a range. Now do I make it "this end of the range" or "that end of the range," or right in the middle? And neutrality was one of the qualitative objectives stated in Statement No. 4.

I guess my question is, "Does this restrict neutrality as an objective?"

CHAIRMAN TRUEBLOOD: Dave wants to comment on this point.

PROFESSOR HERWITZ: I don't want to interrupt but I didn't want to leave the statement--Mr. Mautz wouldn't either--without the other side being kept in mind. I do think the law is developing in the opposite direction: that is, while it is true that those who do not own stock will not be allowed to vote, it does not follow that they are any less entitled to consideration in the preparation of financial statements. We see developing under the aegis of the Securities and Exchange Commission in the litigated cases--and I am not predicting; I am not a forecaster of legal interpretations; I'd prefer to leave that to the accountants if I possibly can--but, I think there is little doubt at the moment that the court decisions are at least moving toward finding the general integrity of the marketplace as an overweening objective. And if that becomes

the critical factor, then the obligation to existing stockholders will become simply part of the broader element of integrity of the marketplace, which will treat the buyer or prospective buyer in the same position as the potential seller or holder of stock.

I just want us to keep that in mind, so we wouldn't feel that bridge has been entirely crossed.

MR. GROVES: Assuming that the financial statements were full of complete integrity then can we come to the conclusion that the person who owns a part of that company has the first call, for instance, in challenging how good a job management did with the resources that they had available, assuming we have this integrity? I think we are assuming that.

PROFESSOR HERWITZ: Well it seems to me that this issue only arises when something has arguably gone wrong, or a choice between the interests of existing shareholders and the interests of others has to be made; the conservatism issue is one often cited as an example of a case where the interests of existing shareholders and prospective buyers may diverge. So far as "first call," the courts are open to everyone. If you are talking about possible responsibility or liability, there is ample room in the courts, I am sorry to say, for plaintiffs from both the stockholder and nonstockholder groups, so I am not sure that's a meaningful line.

MR. GROVES: I am not talking about litigation. I am assuming we have integrity in the reporting. Now, who owns the company and who has the right to challenge decisions made

in good conscience, not decisions made for any wrongdoing or anything like that. We don't reject neutrality nor embrace conservatism.

PROFESSOR HERWITZ: I think you are moving now into the question of who could bring a shareholder suit for impropriety. Oscar is talking about the makeup of financial statements in the total picture of disclosure--and, on that issue, there is no dichotomy; there, the question is whether, given a responsibility to make reasonable and full disclosure, it runs only to existing stockholders, and I just wanted to serve a reminder of the evidence that it may well run to the totality of the marketplace. I think that's what's on Oscar's mind.

MR. BAKER: May I just reverse it for a second and ask Oscar a question? Oscar, do you think we are wrong when we address our reports, now, to the shareholders and to the board?

MR. GELLEIN: No, no. I think that's a circumstance of the times but it seems to me that's quite different from the question of establishing the needs and the uses and then trying to meet them. It seems to me, it's different from the question of identifying the one to whom you address your report.

CHAIRMAN TRUEBLOOD: I would feel that there is no argument about neutrality or integrity; that the issue is raised only by the particular language of this particular sentence, where it says "first consideration, to existing shareholders," whereas the law, Mr. Etra and the public would regard

themselves as equally involved, I doubt it would change any of your conclusions or suggestions.

All right, now, Howie Wagner?

MR. WAGNER: I have a very short and rather a specific question. Page 4 of your original presentation states that "Our experience convinces us that the measurement of value changes other than through transactions is not only difficult but is in no more than an experimental state." The thing that caught my eye here is that you have apparently attempted to make value measurements and I am wondering whether you can comment at any length on just what you have tried to do and what the problems were in accomplishing your objective in these instances.

MR. BAKER: Well I think we spell out a couple of them in the second report, there. We refer there, to the Penn-Central situation where it was common knowledge on the Street and in investment quarters that Penn-Central had over a billion dollars in values--this was publicized. I think we spelled it out; I have forgotten the page it was on.

CHAIRMAN TRUEBLOOD: You said, "a billion-two, as compared with block offers of a hundred eighty-five million," I think.

MR. BAKER: Yes, something of that nature, and it's conceivable, on a value type of thing that could have been perhaps reflected at the billion-two, on a value basis; two years later it would be down to whatever it was--a hundred eighty million, or whatever the number was--and we have this jockey-

ing of values. I think all of you are familiar with the tremendous write-offs that we have--take RCA. They had a tremendous write-off last year that would have been valued, on a fair value basis, at a very high amount; this year, it's down to "zero," so I think you'd have tremendous peaks and valleys which make it very difficult to arrive at objective evaluations.

I don't know whether I got to your question.

CHAIRMAN TRUEBLOOD: Yes.

MR. WAGNER: Yes.

CHAIRMAN TRUEBLOOD: Are you finished?

MR. WAGNER: Yes.

CHAIRMAN TRUEBLOOD: I think the same point comes up in one of the presentations scheduled for tomorrow by the evaluations people--that the fair value approach depends upon where you are in the life cycle and where you are in terms of expectations.

MR. BAKER: Yes.

CHAIRMAN TRUEBLOOD: It's extremely difficult. I have these questions from the floor...

MR. WESTON: Bob, ...--on page 13 of the second paper, there is a discussion of the usefulness of estimates of value. You describe toward the middle of the page--the new projects, and so forth, which management enters into, feeling they have value in excess of cost, and then later they are written down. There is an inference all through that page that there is something wrong or nasty or unfortunate about describing things as they are. I just can't conceive that you

intended the thrust of that page the way it reads. In other words, "Don't tell stockholders when we have an idea which we believe is valuable, and then fails--don't bring them up and drop them down." That is really what happens.

Now, why shouldn't accounting describe that?

MR. BAKER: Well Frank, in one other section we talk about the oil leases in Alaska.

MR. WESTON: Oh?

MR. BAKER: And I think you'd be on that teeter-totter if you were reflecting these all the time.

MR. WESTON: That's what's happening. Why should we not show what is really happening? Those are the economic facts; that is economic reality--why hide that?

MR. BAKER: Well first of all, I question whether that really is "economic reality."

MR. WESTON: People paid that cash for the leases, didn't they? That's economic reality; and they wrote them off subsequently.

MR. BAKER: And they wrote them off.

MR. WESTON: Right.

MR. BAKER: But on a lot of these you don't have a closed transaction. Take the Penn-Central. That would have been written up to two billion without a transaction on it.

MR. WESTON: Well there is some question; I think you used the one-billion figure without really investigating where it came from or whether it was a valid figure. But assuming it was a valid figure, then I am not sure that it

should not have been written at a billion. The fact it came out of some research report saying they've got a lot of valuable real estate--I am questioning your use of the figure as a valid figure, but assuming it were a valid figure--then what's wrong with showing the true estimate of value and subsequent decline?

MR. BAKER: Frankly, the real problem with it is being sure that you have a realistic value.

MR. WESTON: All right. But if we could agree to that, that the value were realistic, then would you agree that it would be appropriate for investors who are buying and selling through this period to have a fair shake?

MR. BAKER: I would want to know how you got to that value before I agreed.

MR. WESTON: All right, I am stipulating that we can get to those values saying that investors sitting back while management tries something and failed, that investors who bought and sold during that period are not being served well by financial statements that don't show those. I am stipulating we have a value that is fair and reasonable. It seems to me we have an inference here, that we should not attempt to describe what's going on.

MR. BAKER: On a cost basis, Frank, the values are reflected in the cost; the expenditures were reflected in the balance sheet, and then when they decided to abandon the project, they were written out of there.

MR. WESTON: I am saying, the cost, under these

circumstances, isn't responsive to economic reality because the value might have been much higher; as you say on page 13, "Management thought the value was higher."

MR. BAKER: Well but Frank, I question whether you are right on that. I believe that perhaps the cost might be better than somebody's...

MR. WESTON: Well I am stipulating that the values are appropriately determined to be reasonable. My only point is that isn't it better to have objectives of financial accounting that call for showing economic reality, which is a nice phrase underlying all these transactions, so that investors coming in and out do get a fair shake, than not to disclose that fact?

MR. BAKER: Well, I don't agree with it.

MR. MAUTZ: Frank, we hope most people don't read that page like you did. If we accept your stipulation, we can hardly disagree. But I hope people recognize what a whale of a stipulation it is. The point we try to make in that page is that it's very difficult to keep up with all those changes in value, or whatever you wish to call them, and to get them recorded. You know, if the stipulation is that that really can be done, then we must come to your conclusion.

MR. WESTON: Look at the last sentence in the third paragraph.

MR. MAUTZ: "What would be the effect of such write-ups and write-downs on the personal fortunes of investors and upon the innovative nature of management, in general?" Because we don't have your stipulation, you see!

DEAN DAVIDSON: Where you are dealing with marketing securities then do you accept the notion of substituting current market value for historic costs?

MR. MAUTZ: We do accept the substitution but provide for a supplementary data on that, Sidney, which gives you the information.

CHAIRMAN TRUEBLOOD: I have three questions from the floor, which in all fairness must be dealt with, interesting as this conversation is. I believe I will know your answer to this question, Dick, "What should be the relationship between accounting and management in the development of accounting standards?" Would you care to capsulize very briefly your point of view?

MR. BAKER: I think there should be a very close working relationship. I think many of our accounting standards have been devised over a period of time by management and in consultation with the outside accountants, and I think that their voices should be heard, and I think other voices should be heard, also.

CHAIRMAN TRUEBLOOD: So it's a joint responsibility.

MR. BAKER: Yes, and there are others involved, too.

CHAIRMAN TRUEBLOOD: And that you would probably put more emphasis on the management participation than some others have?

MR. BAKER: I expect I would, yes.

CHAIRMAN TRUEBLOOD: Yes. Next question, which is a little bit involved; I think it's a fair question; it is written in this way. It says that your paper makes three points--first, that historical cost financial statements present current values with reasonable accuracy; second, that we have no techniques to determine current values with any degree of validity; and third, it would be tremendously upsetting to financial

statement users to shift in the way that Frank was picking out of page 13. The questioner says, "These statements seem to be somewhat contradictory; if we can't determine current values, how do we know the historical costs are acceptably close?"

MR. BAKER: I am not sure we said that they...

CHAIRMAN TRUEBLOOD: I did not check back to the paper.

MR. BAKER: Yes.

CHAIRMAN TRUEBLOOD: I think you did take that position with respect to price-level adjustments. In any event--did you not, Bob--was not it your paper saying, every ten years ought to be enough, if at all...

MR. MAUTZ: No.

CHAIRMAN TRUEBLOOD: It's not your paper--sorry. Well, do you wish to comment on that?

MR. BAKER: Yes, we do. We do not take the position that they necessarily are equal to fair value. We think value is a very, very elusive thing. We don't know whether they do or whether they don't.

CHAIRMAN TRUEBLOOD: But you feel that the risks and uncertainties of going the fair value route are reasonably well known, and somewhat--I was going to say, "suspect." That may be unfair.

MR. BAKER: Yes. May I put it in order, Bob? We certainly think that perhaps we should do some exploration with value and get it in. But let's take a look at it and see what might happen if we tried to apply it realistically

on some complicated companies. I think that much of this has to be done in order that we can say this is a good thing or this is a poor thing. With so many people talking about the wonderful aspects of value, I think we need to get it over into a pilot study and have extensive pilot studies before we would jump the fence and be off the track.

CHAIRMAN TRUEBLOOD: Given the vehicle of the increased research, which is...

MR. BAKER: Right.

CHAIRMAN TRUEBLOOD: ...hoped for, under the Wheat proposals, this is the kind of thing that could go in there pretty quick? Is that your position?

MR. BAKER: Right, correct.

CHAIRMAN TRUEBLOOD: Now you have submitted excellent papers and lengthy papers, and you have waited a long time to be heard. I am just not going to be short about cut-off time so if anybody on the panel wishes to extend it, and if you are willing to stay...

MR. BAKER: We are here.

CHAIRMAN TRUEBLOOD: Sid? Don?

DEAN EDWARDS: I'd like to ask a general question, if I may. Have you and your colleagues considered whether or not the current financial statements, as they are utilized in practice today, are adequate in terms of communicating to the user, or user groups, or if that series of statements should be expanded, or...

MR. BAKER: Well Don, I would say, very quickly that

we can recognize that there is much need for improvement of financial statements, and I think we are in real trouble the minute we say, "Well, what we are doing is satisfactory and adequate." I think we've got to keep pressing and improving the financial statements. I don't think that any of us who could ever feel that what we are doing is--this is "it," and we have arrived with it. So I think there is much improvement that could be made in them.

Did I get to your question?

DEAN EDWARDS: Yes, I think you did, but I would extend it one step further, if time permits...

MR. BAKER: Yes?

DEAN EDWARDS: ...and that is whether or not you think the improvement can be accomplished within the current framework of financial reporting or whether it should be expanded. Now if it's within the current framework, how might it be improved in terms--in the context of your remarks of establishing an institution for the standards board?

MR. BAKER: Don, I am not sure; I am not ready to say that all we need to do is get a motor tune-up on what we are doing. This is the reason why we think we want an ongoing study, and we'd like to have value checked out and challenged, and make sure what the strong points are, what the weak points are. We'd like to have other things, everything proposed for financial statements, challenged--forecasting, whether it ought to be in or should not be in, how much of it, whether it's attested to so that I think that we don't have any quarrel

at all on trying to reach out for further improvement.

CHAIRMAN TRUEBLOOD: George?

PROFESSOR GEORGE H. SORTER (University of Chicago; member, Accounting Objectives Study Group staff): I would like to make a personal comment if I may...

MR. BAKER: Sure.

PROFESSOR SORTER: ...and I am not sure this is shared by the Study Group, but my own personal view is that questions of fair value, forecasting, and so forth, regardless of my personal opinion, are not really properly "objectives" in accounting. We face this tremendous problem of distinguishing between objectives and implementation, and what I hope that the Study Group will do is to show what the objectives in accounting are--discuss how some of these issues that are currently in controversy relate to these objectives, and leave the determination, whether they meet these objectives, to the Financial Accounting Standards Board. This Group should present a framework so that we can all talk the same language and in fact, I think this is often overlooked.

It seems to me it's just as necessary to identify objectives so that we can praise what is presently good as well as damn what may be bad because without these objectives, it seems to me, at least, we have no real framework to be able to do that.

MR. BAKER: George, just a word of caution. I think it's good to have objectives. We go along with that. But let's not set our objectives to such an extent, so far away

from where we are now that the discontents with what we are doing...

CHAIRMAN TRUEBLOOD: I think I can assure you that, within the Study Group and within its deliberations, we think of objectives broadly, and hope they will not be constraining. We keep concerning ourselves about the problems of implementation. We have no intention, at least presently--and I think I can speak for the entire Group--of coming out with a new set of rules which will turn the world over.

MR. BAKER: Right.

CHAIRMAN TRUEBLOOD: It's just not possible, and you and I know that.

MR. BAKER: Yes, Bob, that's the reason we suggest the ongoing aspect of it. We don't expect that from you people. If you could do that, it would be fantastic.

CHAIRMAN TRUEBLOOD: It would be great, if we could. Anything else from the Study Group?

(No response)

CHAIRMAN TRUEBLOOD: If not, thank you very much, and thank you, in the audience, very, very much.

(Whereupon, at two minutes before five o'clock, the session was concluded.)

TUESDAY MORNING SESSION

May 16, 1972

The meeting reconvened in the Georgian Ballroom at nine-fifteen o'clock, Chairman Trueblood presiding.

CHAIRMAN TRUEBLOOD: We'll proceed because of the hour. Our modus operandi will be the same as yesterday. Presenters, or witnesses, will be encouraged to limit their remarks to 15 or 20 minutes. We'll use the rest of the time, which generally runs 40 or 45 minutes in total, for questioning. The procedure will be that observers from the floor will not ask questions from the floor, but will rather write out their questions and send them to the table here for handling.

Again I would point out those of our staff who are in the room to help you with anything, including the delivery of questions: Mike Shannon standing in the back of the aisle; Mrs. Beattie here in the front row; Marty Gans in the front row; Bob Streit way in the back by the coffee; and Paul Rosenfield down here.

So if you do have a question--and we encourage you to ask questions of the witnesses while they are in place--just send them up with one of these people and they will be handled as best we can.

Our first witness this morning is Larry Vance representing the American Accounting Association. Would you explain, Larry, how you handled this in committee so that everybody will understand?

PROFESSOR LAWRENCE L. VANCE: Yes.

The AAA has a fixed policy of promoting expressions of this sort as the opinions of the Committee members, not as official positions of the AAA. Therefore this Committee represents a sample of the AAA, and we think perhaps we reflect in the majority opinion the prevailing view of academic accountants, but we don't pretend that this is an official endorsement of the position by the AAA as an organization.

The Committee operated, of course, by discussing these problems and developing its report; it has one member who dissented and if you have seen the report you can read his dissent. I will not propose to explain the dissent particularly but if someone has a specific question about it, I might be able to answer it.

Would you like me to go ahead with the report generally?

CHAIRMAN TRUEBLOOD: Go right ahead.

PROFESSOR VANCE: Good.

What the AAA Committee has done is to consider what it thinks the most valuable improvement in accounting practice might be, which it conceives to be the use of current cost rather than historical costs. They examined that proposition in the light of the criteria that have been set up by organizations over a period of years who evaluate the quality of accounting information. You will remember that the AAA in 1966 issued a statement in which it set up certain standards by which accounting information ought to be judged.

Later on the AICPA did the same thing, incorporating pretty well, I think, the ideas of the AAA and adding some of its own. The list of concepts and principles that the AICPA sponsored is, first of all, relevance; second, understandability; third, verifiability; fourth, neutrality; fifth, timeliness; sixth, comparability; and seventh, completeness.

Now what we have here is a very simple argument based on a very simple syllogism, namely, that accounting should be as useful as possible. It's most useful when it meets these criteria best. We think current costs meet these criteria better than historical costs and therefore recommend their use.

I think the best thing I can do in the way of summarizing what we have said is to point out the relevance of each of these things or the correspondence of each of these things in connection with current costs.

The first item is relevance. You are all aware of course, that when people engage in business transactions, they are thinking about the present. If they are going to buy a building, they are considering what the building is worth now not what it cost 20 or 30 years ago. We think other economic decisions such as the purchase of stock in an enterprise which owns the building, also will be improved if current information about the reproducible cost of the building is given. This, it seems to us, is more relevant to the decision than the historical cost of the building and therefore accounting might be more relevant to its users in their decisions if it gave this kind of

information rather than only historical cost information.

The second test, or criterion or standard for accounting information is understandability. You notice that I'm using the AICPA list. This standard requires that information presented bear upon or be reasonably expected to have an influence upon the decisions that are to benefit from its use. We think that historical cost fails to give information which is more relevant, because it's not recent, but also that such a presentation tends to suggest to the uninitiated that the historical cost information is adequate. You have to be pretty unsophisticated to believe that, but in a complex world it's easy to become unsophisticated on a particular point when you have a very complex system to deal with.

The nearer you can get to the present in terms of costs, of course, the closer would be the indication of what the values are with which you are dealing, and therefore you would be more nearly relevant to your decision with this kind of information, we think, than with the older information.

Understandability has been suggested as one of the criteria. One thing to be noticed about this is that people think in terms of current transactions, current price levels, current costs, if you like. Even those who are concerned to recognize that the accounting data conventionally don't always refer to the current price level are impeded in their efforts to adjust them by such things as the complexity of the enterprise which has a variety of assets purchased at different price levels so that individual adjustments to the separate

parts are necessary. It would be more understandable if all these bits of data could be brought to the same price or valuation basis which current cost of course would do.

I have the feeling--and the Committee had the feeling --that even corporate managements in very large organizations have some difficulty in this connection even though they have access to the records because their assets are numerous and widely spread and to make an adequate adjustment isn't something that can be done easily and subjectively but has to be worked out rather thoroughly on the basis of all the data.

I might remind you that a number of years ago in the 1950's when the AAA made a study of the effect of general price level adjustments on statements, one of the companies which was studied read the report and then cut its dividend. directors of that company had not realized that on a price level adjusted basis they had been paying out more than their earnings in dividends. This can happen to management as well as to the outside investor.

Understandability, therefore, we think would be improved by bringing the data to a current level and a uniform level on that basis.

Now verifiability is one of the characteristics that most commentators think accounting ought to have. It has been emphasized vigorously over the years, and it perhaps is the chief basis for support of historical cost. Historical cost is eminently verifiable. The Committee as well as most accountants are agreed that verifiability is an important characteristic of

accounting which has to be preserved in view of the fact that accountants serve a variety of customers, third parties are involved, the public interest is involved, and so on.

With regard to this quality of verifiability we ought to notice that what we are proposing is adjustment to current costs based on indexes which are not necessarily constructed by the accountants, and in almost all cases would not be, but which are the results of studies of government agencies and trade associations and others who prepare market data. If these indexes are used you eliminate the opportunity for personal bias or for deliberate manipulation and you make the results verifiable because anyone can take the same indexes and the same historical cost data and arrive at the same result. We believe, therefore, that current cost qualifies very well from the viewpoint of verifiability.

The fourth characteristic that the AICPA studies suggested was neutrality and I think this corresponds pretty well to what the AAA previously called freedom from bias. It means that accounting information should be prepared without favoring the interests of any individual party or group likely to be using it.

Now one way of serving the neutrality standard is to include information that is as nearly current as possible since persons with knowledge of the activities of the concern from the inside will probably have a better knowledge of the current condition or the current costs or current value of the assets than persons on the outside. We are all aware, of course, of the take-

over activities of the last 20 years or so in which knowledgeable people were able to persuade stockholders to trade their stock on a basis which perhaps the stockholders would not have accepted if they had known what values really were represented in their companies' assets. Current cost information would improve the data from the standpoint of neutrality in this connection.

Timeliness is a characteristic also recommended by the AICPA. This quality, of course, is often thought of as equivalent to promptness; statements should be prepared expeditiously and published as soon as possible. It may, however, also be interpreted as requiring that the methods or principles used be designed to give information that is timely in the sense that it is as nearly up to date as possible, as complete as possible, including as much of the events that have affected the enterprise as one can reasonably incorporate in the accounting data. Current cost, of course, would bring things closer up to date than historical cost and is therefore more timely in this sense.

Timeliness from the standpoint of the mechanical production of the statements, of course, is something that we have to work out on the basis of the development of computer methods, and so on, which enable us to process the data more quickly.

Comparability is our next characteristic. This, of course, has to do with such things as comparison of year-to-year results of one firm and comparisons between different firms in the same year, of course, including comparison of firms or different character. Of course, consistency in accounting

methods is an element of this because uniform methods enable you to measure things on the same basis in different years and between different firms.

Uniformity of practices, therefore, is desirable; of course, we're all aware of the effort to get this kind of thing over the years. If we went to current cost, we would, of course, automatically bring a great deal of uniformity into the picture because we'd eliminate the alternatives that have been characteristic of the use of historical costs. For example, the problem of inventory valuation would be automatically solved, and you wouldn't have to worry about first-in-first-out or last-in-first-out because you would be on a current cost basis throughout. By eliminating these alternative choices automatically, comparability would be immediately improved.

The last characteristic was completeness and this term suggest sufficiency or adequacy of the information provided. For example, a statement that presents surplus without distinction between retained earnings and paid-in capital would be defective in this sense. We suggest that a statement which presents outdated historical cost is also incomplete in the sense that it doesn't give as much information about the events which can be observed as can be given. We can make the statements more complete in the sense that they incorporate more of what has happened from an economic viewpoint if we use current cost.

The report also includes some reference to traditional ideas in accounting such as accrual, adequate disclosure, consistency, conservatism, the matching concept, and the concept of

materiality. We can comment on all these with regard to historical cost and with regard to current costs. Let me briefly mention just a few of them.

We have all long recognized that accrual accounting is appropriate in any complex situation. The characteristic of this is to incorporate into the record as much of the economic data as we can, in the sense that even though a transaction isn't completed by settlement in cash, we nevertheless reflect its effects in the statements. Development of current cost data would be simply another step in that direction, incorporating a little more of what we are able to know about the transactions and the economic events impinging on the firm and might be looked upon as a kind of extension of the accrual method.

Adequate disclosure, of course, refers to the completeness of the statements; we can conceive of this in connection with current costs as a matter of disclosing something that we know, that we can reasonably verify, which meets the other criteria for accounting information, and which therefore give a more adequate disclosure of the events that have impinged on the organization than if we stuck just to historical cost.

The traditional requirement of consistency, of course, is designed to prevent misinterpretation of the statements through bogus changes which reflect changes in methods rather than changes in the economic events. A good deal of the shifting about that we can get through the use of different accounting methods would be eliminated by conversion to current cost which would improve the area of consistency.

Conservatism, of course, has been a traditional characteristic of accounting and although it's less emphasized now perhaps than it used to be, we still have some concern about overoptimism. People who issue financial statements are sometimes encouraged, of course, to gild the lily a bit; therefore we have to consider whether or not current costs give an opportunity to move too far from the concept of conservatism. Our opinion is that conservatism should be replaced by such standards as relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness, rather than to stand as a primary consideration for accounting by itself.

If you make it a consideration on its own, you tend to encourage undervaluation, as everybody knows, and this always affects somebody adversely.

Verifiability, it seems to me, is a much more important consideration than conservatism and we have already spoken of the ability to maintain verifiability while using current cost.

I might comment here at the moment, while I think of it, that the fears that many people have about using so-called value or fair value accounting should be laid aside and we should be very careful to define what we are talking about; that is, current cost in the sense of replacement cost or reproduction cost is to be calculated by means of objective or general indexes, not on the basis of somebody's opinion. We all remember the experience of the 1920's, of course, in this connection.

Another concept in accounting which has been discussed a great deal is the matching concept. This is akin to the concept of accrual which tries to match better the revenues that are obtainable from the activity of a particular period with the costs that are attributable to it even though they may not have been settled in cash. If we use current cost we can determine what has happened to the enterprise in terms of increases in values, of changes in price levels, or changes in economic opportunities to use the assets--specific price levels, in other words. We can bring the matching process to a little higher state of perfection by incorporating into the calculation more of the events that have occurred than we do if we stop short with historical cost data.

Finally, I'd like to make one other comment about materiality. Obviously, we can apply that concept in using current cost just as we apply it in using historical cost. If a change from one current cost level to another is insignificant, there's no reason why we should bother about it. Certainly, immaterial things don't need to be reported even though technically we're presumed to be on a current cost basis.

I might also comment here that there's no reason to assume that we're talking about current costs as a floor; we're really talking about them as a ceiling. If you have an asset which has reproduction cost of a million dollars and you cannot use it effectively to earn a return that would justify a cost of a million dollars, you should expect to write it down just as you would expect to write down a historical cost figure.

I think that covers all the significant points that the Committee is concerned about as far as the majority goes. I don't intend to try to explain the position of our dissenter. He sometimes, I think, attributes to the majority meaning that they did not express or intend. If you have some questions about his remarks, I'll be delighted, of course, to try to answer them.

CHAIRMAN TRUEBLOOD: Thank you very much, Larry. This initial question is in relation to current values, or replacement values, or fair values, just using the words loosely. In one of the papers that's coming up this afternoon, the point is made that current values run on a scale, the low point being forced liquidation and then an upward slope in orderly disposal to a highest value in a going concern situation.

We ended the conversation yesterday afternoon with some despair about the illustration of Penn Central, in which analysts, or what have you, have indicated that fair value of real estate might have been something like \$1.2 billion. When it came to getting rid of the stuff on the block, the price became \$185 million. So there was much concern expressed about the practicability or the reliability or the verifiability, using some of your terms, about this kind of technique.

PROFESSOR VANCE: Yes. Well, I think this goes back to the comment I made a while ago about the fact that you shouldn't take it as the one and only possible method in accounting, but that you ought to look at the result in a particular case. If you have an asset which would be reproducible at \$10

million but it isn't worth any more than a million, you should ignore the \$10 million and use the \$1 million.

I don't have sufficient familiarity with the Penn Central case to comment in detail on that, but I assume that in some of these cases forced liquidation produces values quite apart from what you might expect in an orderly use of the asset, so that you have that problem in any case. The use of current cost neither disposes of it nor requires that you do anything differently about it from what you would do with historical cost.

CHAIRMAN TRUEBLOOD: So when you are talking fair value or replacement cost, or what have you, you are assuming a going concern?

PROFESSOR VANCE: Yes, ordinarily we would assume a going concern. If we didn't have one, then we would certainly want to make whatever writedowns were important.

CHAIRMAN TRUEBLOOD: Could you reach for an example off the top of your head of an internal, ongoing accounting situation in which a significantly different decision might have been reached if fair values were being used? You gave the dividend example on price level adjustments but could you reach for an example of an accounting decision which might be different, given fair values, than -- ?

PROFESSOR VANCE: I have a little more trouble with an internal decision than with an external decision.

CHAIRMAN TRUEBLOOD: Well, take an external decision.

PROFESSOR VANCE: I know of a particular case. There's

a large concern in California which once was a ranch and after a while it discovered that the area of ranch land had a lot of oil underneath it, so oil wells were drilled which began to produce oil.

Over the years this ranch land was valued on a historical cost basis and I think the historical cost goes back to something like 1890. After a few decades, the treasurer of the organization was concerned about this valuation. He had read the AAA report and asked for a little advice in connection with perhaps implementing it in this case. Before it could be done, somebody made a merger offer and the stockholders thought this offer looked so good that they accepted it. Nothing ever happened about the adjustment of the assets and my own feeling is that the stockholders really didn't know what their land was worth.

MR. PARKER: Mr. Vance, could I posit some things here, and if we agree to them for the sake of argument, see how the replacement cost technique would affect us?

Let's suppose we have a very capital intensive company and its got lots of 50-year fixed assets. And let's further posit for the sake of argument that this company has nearly perfect ability in the future to adjust the prices of its products to cover whatever higher replacement costs it has to sustain. And let's lastly posit, just for the sake of argument, that the only reward the investor can get from an investment in this company are the dividends he receives and capital appreciation, if it occurs. And again, just for the sake of argument, let's

posit that the capital appreciation is going to be directly commensurate or proportionate to the increase in dividends in the future.

Now with a lot of 50-year fixed assets, I would assume that even if we don't know what kind of assets they are, if we are basing this on replacement costs, there will have been considerable increase in those replacement costs compared to the historical costs that would be on the balance sheet. So we would have, probably, quite a sizable writeup in those assets to get them to replacement cost.

Is this going to help relevance, understandability, or neutrality, to record on the balance sheet all these things that don't affect any cash flow and don't affect any current or future ability to pay dividends to the stockholders?

And further, if you do write these assets up significantly, as it stands now I think most investors understand enough about historical costs to know that they are not a very good index of sale value, if you will, or liquidation value; whereas, if you wrote them up and said that this is replacement value, might not there be some risk that the investor would think that this is what they now represent as a liquidating value?

PROFESSOR VANCE: I suppose that investors will always be able to misinterpret the data one way or another. We should, of course, make it as clear as we can, with language and otherwise.

I would say that the investor would have a better in-

dication of what kind of capital he possesses and therefore a better basis for judging whether the income that's being earned is adequate.

MR. PARKER: A better idea of the capital he possesses? Would that indicate that you could sell all these plants for this replacement cost value?

PROFESSOR VANCE: Not necessarily. It might be that a sales value would be something different, but it's a harder thing to get hold of. The Penn Central case is an issue in point.

MR. PARKER: Well, the Penn Central case, I think, has been discussed at length. Didn't we have an indication, Bob, that that \$1 billion figure was a gross figure, ex the mortgages, and that when they finally got the offer, it, of course, had to be net for the equity? So maybe the gross figure should have been \$700 million or \$800 million but there were always \$500 million or \$600 million worth of mortgages sitting there.

CHAIRMAN TRUEBLOOD: I don't think that distinction was made in the discussion.

MR. PARKER: I think it was in the newspapers however, when the final offer was made.

PROFESSOR VANCE: Full disclosure might have been helpful.

MR. PARKER: Well, I think the disclosure was on the balance sheet.

PROFESSOR VANCE: Presumably the investor is going to make his decisions on the basis of whether he considers he's

earning an adequate return on his investment. Now, you said he might do this with regard to the dividends. He may do it with reference to the stock quotations on the market. He may ignore the accounting altogether. That's always possible.

MR. PARKER: Well, for the sake of argument we accepted that he's got the dividend and the capital appreciation in the future is going to be, for the sake of this argument, commensurate to the increase in dividends, and that the company has the ability to increase or change the price of its product to cover whatever increases there are in replacement costs, so it is going to go on about the same in the future as it has in the past.

PROFESSOR VANCE: Well, you can always argue that---

MR. PARKER: You may recognize the public utility industry about this time.

PROFESSOR VANCE: You can always argue that accounting doesn't really contribute anything to investor decisions, which some people do; but in so far as accounting is going to give as much information as it can and be as helpful as possible, I think the current cost information would give the investors a better idea of the value of the assets that are being used.

MR. PARKER: A better idea of the value at which they could be sold or liquidated?

PROFESSOR VANCE: No, it doesn't follow that they could be sold or liquidated at that.

MR. PARKER: At which they could produce income?

PROFESSOR VANCE: No, at which they could reproduce

the assets. You have got assets that would cost you this much to buy right now.

MR. PARKER: All it will tell him is how much it costs to reproduce those assets.

PROFESSOR VANCE: That's right. That's right.

MR. PARKER: It doesn't contribute any other relevance?

PROFESSOR VANCE: It doesn't pretend to predict the future earnings. It doesn't pretend to predict the selling price under forced or gradual liquidation.

CHAIRMAN TRUEBLOOD: Frank Weston.

MR. WESTON: I think this same point that Reed Parker is raising is really a very important one. Many of the papers submitted to our group on this question of fair value do zero in on property, plant, and equipment, and that's basically what Reed Parker is inquiring about.

What would the format of the income statement be under that kind of an approach? And I guess I still have the same question that Reed does: How is the computation of earnings or the disclosure of the changes in value useful or relevant to the investor? Could you give us a little more information as to how you visualize the income statement to appear?

PROFESSOR VANCE: We would visualize the income statement as showing the increases, if they were increases--they might sometimes be decreases, I presume--from one value at the beginning of the year to another value at the end. These would also be able to be divided between increases which had previously been recorded that were realized as against those which had been

recorded which were still unrealized. The investor would then have an indication of what changes in reproduction cost were involved, which presumably would give him better information about the changing in basic values of the assets.

We all know, of course, that the value of an asset is the present worth of its future net rents and all we can do in accounting is to get as good a stand-in for that concept as we can.

The Committee thinks that reproduction cost would do that better than historical cost, not that it would do it perfectly. And then the income statement would be expanded to include both the unrealized increases or decreases that result from this process and the realized portions, which would leave them the earnings currently based on current revenues, with deduction for use of assets at current cost. You wouldn't have an income figure then which incorporated without distinction, capital gains, so to speak, and current earnings.

MR. WESTON: There have also been observations that in a changing economy it's very seldom that a corporation, in fact, replaces physically or in some cases even in terms of utility, its present assets; and I gather from your comments that that isn't relevant or important in your approach to using replacement cost. You don't infer that they will in fact replace the assets.

PROFESSOR VANCE: No, we don't intend to infer that; we do intend, I think, and some place state explicitly that where the reproduction cost calculation is to be made, it should

be made with regard to the utility or the function rather than the physical embodiment of the assets.

MR. WESTON: Well, that's what disturbed me because there seems to be a little conflict in your paper. At one point you say you will, in fact, replace the utility of the assets but then your emphasis on the computation is on indices which don't purport to do that. I wonder: Which of those do you really believe should be used? They are quite different ideas.

PROFESSOR VANCE: My feeling about that is that the choice of the index may be the thing that's involved. For example, if you have a stone building, and you're not going to replace the building with the same methods of construction--you're going to use steel instead--to get the same service, you would use the index number or reproduction of that facility in steel--whatever might be currently used.

So that instead of trying to refer to the physical reproduction, you refer to the service involved, adapting yourself to techniques as they change.

MR. WESTON: I can see you might have a problem if the price difference between steel and stone, when you first built your building, were quite different. You would get a very strange answer if you applied a steel price index to a stone building.

MR. PARKER: What would you do in the case of a public utility where the obvious replacement or the next asset that comes in is an atomic energy plant whose capital cost would be much larger than a fossil fuel plant, but what you have on your

books are fossil fuel plants?

DEAN DAVIDSON: I guess you can't solve all your problems by this approach.

PROFESSOR VANCE: I guess that's the answer.

CHAIRMAN TRUEBLOOD: It's Howie Wagner's turn here. He's been waiting in line quite a while.

MR. WAGNER: You mentioned that one of the advantages of replacement cost through the use of indices would be the elimination of bias and I think this is a very critical point. This relates, obviously, to construction, but what about real estate--land itself?

PROFESSOR VANCE: I would say that you ought to have indexes regarding real estate also.

MR. WAGNER: Are there such indexes?

PROFESSOR VANCE: The real estate people do collect them and you will find information about the changing values for industrial land or commercial building land in downtown areas and various other areas. It would have to be classified, of course, so that you would get a fairly uniform sample of a particular kind of real estate. Since each plot of real estate is unique, obviously it isn't perfect, but I think you can talk about the changes in cost of commercial buildings in midtown Manhattan or commercial sites in midtown Manhattan realistically.

CHAIRMAN TRUEBLOOD: Interestingly enough, Howie, out of one of our interviews which I presume you have seen, Marty Weber, just back from the government, indicates that the Army is using some commercially acceptable properties in Hawaii

which are carried on the books of the government at \$10,000 and are worth in the commercial market \$185 million. They are building an officers' club and he estimates the fair cost of each night's room rental at \$20,000.

Sid, did you want to--?

DEAN DAVIDSON: Just one brief question.

One of the topics that we're concerned with frequently is the notion of stewardship--of how well the resources are managed. Which measure, even on Reed's 50-year-old plant, is likely to give us a better feeling about the effectiveness of management in producing reasonable returns on their investment, do you think, the historical cost one, or the current value one?

PROFESSOR VANCE: I don't think historical cost is good for anything in stewardship except physical stewardship in terms of what the management ought to be able to earn a reasonable return on. They ought to be able to be able to earn a reasonable return on current values and we have recommended replacement values because of their verifiability, and so on. Ideally, of course, there might be some other more accurate calculation of value that you would hold the management responsible for. A management that can return an adequate income on historical cost and not on current cost obviously isn't doing as well as most investors think they should.

CHAIRMAN TRUEBLOOD: I have a question from the floor indicating that you talked about current costs in the sense of replacement values or fair values, not necessarily to the exclusion of, but at least you did not mention alternatives such as

discounted cash flows or exit prices. Would you care to comment on that? Is that deliberate?

PROFESSOR VANCE: More or less. Discounted cash flows are ideal. All of us who have had a course in economics remember that the value of anything is the present value of its future net rents. The only difficulty is you can't find the future net rents except in a few contracts such as bonds where you have a responsible borrower who can definitely pay you so much per year for a specified period of time.

In regard to an asset such as a machine or a building or a piece of land, we can't get that information. So while we'd like to have it--and if we did have it, I suppose we could do away with accounting and a lot of other things--we have to do something different.

Exit prices are advocated particularly by a well-known accountant in Australia. It seems to me that they don't meet the standard of verifiability to the extent that accounting ought to meet it, and therefore we can't use them very successfully; I think there's also an objection to it in the sense that exit prices are not the basis for decisions to the extent that you might assume. People in organizations usually like to keep the organization going and they like to be able to earn an income from it. There are cases on record in which the stock of a corporation has sold for less per share than the amount of cash in the corporation's treasury because everybody knows that the officers are not going to liquidate the corporation and pay out the cash. They are going to keep on going and the investors

think they are going to keep on losing money.

CHAIRMAN TRUEBLOOD: Is it fair, in terms of Ray Chambers' use of the word "exit values", to relate that to what we might call a pounce value, a forced liquidation value?

PROFESSOR VANCE: Yes, I would think so.

CHAIRMAN TRUEBLOOD: That is fair?

PROFESSOR VANCE: And it seems to me that this represents a concept of a market for the assets which isn't really relevant to the use of the assets, for the most part.

CHAIRMAN TRUEBLOOD: So what you are talking about, and continue to emphasize, is the concept of replacement or fair value in the context of going, operating concerns?

PROFESSOR VANCE: Yes. Definitely.

CHAIRMAN TRUEBLOOD: Another question from the floor: Intangible assets, such as patent rights, technical information, good will, and so forth are often expensed currently under present historic cost accounting principles. I don't know that that is a completely correct statement, but you get the idea. To what extent would your views change this notion about the intangibles part of the balance sheet?

PROFESSOR VANCE: With regard to expensing them currently, I don't think these current cost ideas have any particular impact at all because that's a question of whether or not you are going to retain an asset on the books or not. If you can have verifiable evidence that you have got an asset and you are justified in retaining it presumably you are not justified in writing it off arbitrarily.

We might comment in addition in connection with this that these assets are not ones that are amenable to a reproduction cost technique. You can't get an index that describes patents very well. So what you have to do with these, I think, is to go as far as the adjustment to a general price level change will permit and be satisfied with that.

CHAIRMAN TRUEBLOOD: Did your Committee take any position-- I just don't recall your paper that well--about change in practice with respect to intangibles generally?

PROFESSOR VANCE: No, it didn't take any special position at all.

CHAIRMAN TRUEBLOOD: Oscar, I think, is next.

MR. GELLEIN: Larry, you quote early in your paper from ASOBAT about accounting and its purpose, pointing out that it is that process whereby information is put together to permit informed judgments and decisions by users.

Now you then test historical cost and current cost against the qualitative objectives in Statement 4 and conclude that historical cost does not meet those objectives and that current cost does.

Now when we conducted our interviews, the sample wasn't large, but we talked with very sophisticated users, and we really encountered no enthusiasm for price level adjusted financial statements. Now, of course, your solution does present price level adjusted financial statements. How do you explain the fact that the users have no enthusiasm for it?

PROFESSOR VANCE: Well, I think I have had the same experience, Oscar. For example, we had a Symposium on Financial Accounting at the University of California one time in which a

prominent financial analyst spoke. He had no interest in price level adjusted statements and I think the answer is that people who have been successful with the existing system and aren't particularly oriented to any other one tend to resist change to another one and get along fine with the one they have got. It's a matter of not really wanting to adapt themselves to a new situation and feeling satisfied with what they have been able to do in the past.

It's still a little bit like social change. People who are getting along well under the current rules and regulations like to keep on that way, and others who think they need a change, of course, agitate for a change.

I don't believe it's anything more than a common human tendency to stand with what you know and what you have been successful with.

MR. GELLEIN: Well, then, how do you conclude its useful?

PROFESSOR VANCE: Well, I have the feeling that maybe I have a more objective view on it than some of these people.

DEAN DAVIDSON: Is he asking for price level or specific prices?

MR. GELLEIN: It's price level with specific indices.

DEAN DAVIDSON: Well, that's not price level.

MR. GELLEIN: Well, it's not general price level, but it's specific price level indices.

DEAN DAVIDSON: Well, all right, if you want to call that a price level.

CHAIRMAN TRUEBLOOD: I thought, Larry, you were talking in a broader sense of replacement costs or giving consideration to price

level as distinguished from price level alone.

PROFESSOR VANCE: Well, I'd like to make another comment here too, and that is that if you use specific price indexes and make an adjustment, one thing you may incorporate in your statements--and this goes back to the question we had a while ago about the form of the income statement--you can indicate how much of the change is attributable to a general price level increase and how much also, then, represents change with regard to this specific asset over and above the general price level change. So you can improve the information to that extent also.

CHAIRMAN TRUEBLOOD: But the accretion in value in the Hawaiian officers' club is not strictly a price level thing.

PROFESSOR VANCE: It was certainly not due in any large degree to the general price level changes, but to a specific price situation.

CHAIRMAN TRUEBLOOD: But you would recognize that and include that kind of an adjustment if you were a commercial enterprise, would you?

PROFESSOR VANCE: Oh, yes. Definitely.

CHAIRMAN TRUEBLOOD: Okay. Howie Wagner, I think in the specific terms of price level adjustment you did a major experiment a few years ago and found that there were relatively few decisions that would have been adjusted internally as a result of that.

MR. WAGNER: Well, as a matter of fact, we did this, but found that there would be no decisions that had been made

that would have been altered as a consequence of going just on strictly a price level adjusting basis. Of course, this doesn't take into account all the replacement cost adjustments.

PROFESSOR VANCE: I can cite another instance. A study was made of Cummins Engine, was it not, and published in the Accounting Review a number of years ago, and they found that price level adjustments didn't make much difference; the reason they didn't was that the company had expanded so rapidly over the last ten or fifteen years that almost 80 or 90 per cent of their assets had recently been acquired so that you didn't have much of a base that represented old outdated prices. So, of course, whether or not it's significant or important depends on each individual case on the age of the assets of the particular company and their particular fortunes.

CHAIRMAN TRUEBLOOD: I think I have been ignoring Don Edwards.

DEAN EDWARDS: Larry, did you mean to imply that you would use current value statements singularly in reporting or would you use multiple column reporting?

PROFESSOR VANCE: The original statement in 1966 suggested multiple column reporting, primarily, I think, because we looked upon it as kind of a transitional situation. The current report doesn't recommend that any longer. It simply suggests current costs.

DEAN EDWARDS: One of the executives that Oscar referred to that we interviewed was a former controller, but now president, of a large company that had 800 fast food locations

around the country and the specific question we asked him was whether or not he would like to know the current value of those locations as a measurement of return on investment. His answer was no.

Would you like to respond to that in any way?

PROFESSOR VANCE: Yes. I think if I were in his position, I might feel the same way because with the lower valuation in a period of inflation you get a higher return. He wouldn't look quite as good if he reported the current values and the same income.

CHAIRMAN TRUEBLOOD: One more question from the floor and then I think we'll move on. As a defense contractor performing cost reimbursement type contracts for the U.S. Government, I believe the questioner says, I would have difficulty using current values in billing the government.

PROFESSOR VANCE: I'm sure the government might be reluctant, but the government presumably ought to pay you based on current reproduction costs; otherwise it's stealing part of your assets.

CHAIRMAN TRUEBLOOD: I have another one here if you will give me a minute.

MR. WESTON: While you're reading it, I might ask whether you have any experience in anyone applying this particular technique to any corporation?

PROFESSOR VANCE: Unfortunately not. We'd like a volunteer if we can get one.

CHAIRMAN TRUEBLOOD: The gist of this question which

is rather long and involved is the difficulty of determining current values in an incipient or developing situation, such as, let us say, the new town aspects of Reston, Virginia, and that sort of thing, and I suppose it goes back to my sloping evaluation kind of thing. What would be your position there, that it's a matter of reexamination year by year? That is, if you flop, it goes down, and if you really take off, it goes up.

PROFESSOR VANCE: I think in that case you will have specific assets, such as land and buildings. You presumably ought to be able to get indexes which would indicate what current reproduction costs would be, what you would have to pay to get similar land, what you would have to pay to build similar buildings, and you would use those. If your estimates of what you can do or your decisions or your designs are bad, so that people don't respond to your enterprise, it might be that you couldn't use current costs properly because you have made commitments which destroy the values for your particular assets.

But in general, without regard to a concern about whether or not you have missed the boat somehow in your own promotions, presumably the indexes ought to indicate the values you are using, for which you ought to be responsible, and on which you ought to be able to earn a return.

CHAIRMAN TRUEBLOOD: But, then an anticipated success followed by an unexpected failure would give you a degree of volatility in your income accounts that we do not now have necessarily.

PROFESSOR VANCE: If you were using current costs and costs were going up but you were failing because of your own policies or administration, it might be that you would have values reported going up for a while and then you recognized your own failures and wrote them down.

CHAIRMAN TRUEBLOOD: And you say that those ups and downs should indeed be recognized as they go up and down?

PROFESSOR VANCE: I think those represent the best information you can get about what's happening.

MR. WESTON: Along the lines of that last question, we talked yesterday about the Alaska oil leases and there was some discussion of the large amounts expended and the fact that values seem to be going up and down based on ecology and costs and future price levels, and so on. Would that be an example, along the lines of the last question, where you would look to reproduction cost or replacement cost in terms of what you could buy it for today and that those changes also would run through the statements?

PROFESSOR VANCE: I would think so. In a volatile situation you will simply have more vigorous fluctuations but I think the investor is entitled to know these.

CHAIRMAN TRUEBLOOD: Thank you very much, Larry. We appreciate all of the cooperation we have had, consistently, from the AAA.

Next is Arthur Andersen. George, will you introduce yourself?

MR. GEORGE CATLETT: My name is George Catlett and

I'm accompanied by Norman Olson. We're partners in Arthur Andersen & Co.

Norman and I appreciate having this opportunity this morning to present the views of our firm to your Study Group. The time available will not permit us to do anything other than give you some very brief comments. We do have in preparation in our firm a comprehensive document setting forth our conclusions and our reasoning in more detail and we plan to submit this to your Study Group as soon as it is completed.

Norm will now give you a brief summary of our views and then we can go to the question period.

MR. NORMAN O. OLSON: It seems to us that perhaps the difficulty we have encountered in searching for agreement on objectives may be due in part to trying to cut through the layers of networks of concepts, postulates, principles, conventions, and methods; but if we can get underneath all of that, it seems to us that the idea--the basic idea--is a simple one even though its implementation may be very difficult.

Without defining our terms for the present, aren't financial statements intended to provide some information on two fundamental questions? And those are: How much wealth does the company have and how successful is it likely to be in producing additional wealth in the future?

There are a number of general considerations and factors that we feel were helpful in leading us to our particular conclusions as to the objectives. There isn't time to run through all of these but I would like to mention just two which

I think are particularly significant.

First of all, it seems to us that financial statements should aid the investor and others in appraising the future. The statements are intended to present a picture that is true of the present and information about what has happened in the past concerning business enterprises. Yet almost all economic decisions made from that information are oriented to the future. Therefore, financial statements should present information that is as useful as possible to investors, creditors, and others in assessing the future prospects of a business--the basis for all economic decisions.

And second, we feel that it is important that the accounting function be segregated from the investor or user function. The evaluations and interpretations made by investors, based in part on information provided by financial statements, should not be allowed to affect or to be introduced directly into those statements. And we believe that failure to observe this segregation of functions in the past may have introduced a circularity that has reduced the usefulness of financial information at times and has resulted in confusion in the resolution of individual problems, and perhaps even in a growing confusion, for example, over the responsibility for financial forecasts.

Segregation of these functions demands that a careful distinction be made between presenting financial information and predicting the future; as you all know, that is not always a clear line. While financial statements should be presented

in a manner that will assist as much as possible in assessing the future and its risks, the role of accounting or financial statements is not to predict or to interpret the future. That's the function of the investor.

The statement user has the responsibility for predictions and reaching decisions. Accountants should not attempt to relieve the statement user of this responsibility. Otherwise, accountants and not the investor should be entitled to the rewards of risk taking.

And we see it now, auditors are almost being charged or considered responsible for the quality of investments, versus the quality of financial reports.

Well, we feel those are two basic considerations to bear in mind, not only in reaching agreement on objectives, but perhaps also in individual decisions as to the selection of accounting practices and presentation of information.

In our view, the overall purpose of financial statements is to communicate information concerning the nature and the value of the economic resources of a business enterprise and the interests on the part of creditors and the rights of the owners in those resources and the changes in the nature and value of those resources from period to period.

We recognize that the term "economic resources" has been defined in various ways and we might ultimately settle on a different term for that reason. But for our purpose, we have defined "economic resources"--and this definition has been used by others--as those elements of wealth which possess three basic

characteristics; namely, utility, scarcity, and exchangeability.

The term "exchangeability" as used here is not intended to suggest that an economic resource is necessarily immediately marketable nor that it is being held for immediate sale by a business. It does mean, however, that an economic resource is separable from the business as a whole and that it has value in and of itself. This will be a difficult distinction to make for the identification of economic resources from other elements of wealth but we believe that it would provide a useful thrust and an emphasis and if these views were adopted, of course, this identification would become a major concern in the accounting process.

Now, this definition of economic resources would tend to exclude from the balance sheet a myriad of unidentifiable intangibles or attributes of a business that may give it an advantage over others in a competitive system and hence enable the business to achieve profits beyond the pure cost of money. These intangibles and attributes include a whole range of elements from the quality of management to the quality of product and human resources, but these attributes lack the basic characteristics of exchangeability or separability from the business as a whole. And these attributes or unidentifiable intangibles, may be extremely valuable--much more valuable than the economic resources, in many cases; they may arise through deliberate effort or fortuitous accident; but information about their quality and potential value is conveyed primarily by information on earnings rather than through direct measurement in the bal-

ance sheet. And in a sense, adopting this view, at least, the conversion of the intangible wealth or intangible attributes of a business into economic resources is what constitutes the earnings process.

Now, under this definition the balance sheet would also generally exclude categories of deferred charges not directly identified with economic resources and particularly when deferment is based solely on the expectation of matching such deferred amounts against future revenues. Economic resources may arise in the future from such expenditures and this fact also will be reflected in earnings.

Now, we have talked about value of economic resources. We feel that it's important to distinguish those values from the value of the business as a whole; our view of the objectives of financial statements does not embrace reporting market value information about the equity of owners in the business. To attempt to present the current value of the equities of owners would be to attempt to value the business as a whole; and to repeat, that is an investor function. To reflect in the financial statements the investors' decisions would introduce this hopeless circularity of which I spoke earlier.

I believe that agreement on this point, one way or another, is crucial to a meaningful statement of objectives.

Well, you noticed, I'm sure, that we used the term "value" of economic resources--a fighting word, as we have observed. Let me emphasize that it is not our purpose to encourage a radical and sudden departure from existing practice

in the area of financial reports. Rather, we would like to encourage a redirection of attitudes and to establish goals, even though those goals may never be completely obtainable. In this way solutions to accounting problems can be sought in a cohesive manner directed toward common goals.

Our statement of purpose does not contemplate a whole-sale abandonment of the transaction oriented cost approach. Transactions translate values into costs that under many circumstances will be a continuing, dependable, and reliable means of conveying value information about economic resources. I doubt, for example, that the value approach would justify extensive, frequent writeups of plant and equipment. In fact, under the value approach we might have more writedowns than under the cost matching emphasis. And, actually, the value approach, when combined with a hard economic resource test for the admission of assets to the balance sheet, may result in more prudent financial information in many cases than that which flows from our present concepts.

We also feel that the value objective is sensible and not really a radical one because we believe that this objective is intuitively held now by a wide range of users of financial statements, including business managements. I think many of us, as accountants who prepare statements, intuitively feel that value is what this game's all about. Much of our literature, of course, has denied value as an objective. We speak of depreciation as a process of allocation and not valuation. But the resolution of day-to-day problems in accounting belies the liter-

ature. There is, for example, a continuous concern among auditors in practice today with one aspect of value, and that is: Is the asset at least worth its carrying value? Is its carrying value recoverable from future operations?

Businessmen, accountants, and knowledgeable users consider many balance sheets to be almost worthless in the sense of conveying useful information. And why is this true? Because they don't regard the information as indicative of the value of the assets.

Now isn't this attitude really a subtle acknowledgment of what our objectives are, or should be?

The value of an economic resource at any time is the price it commands in exchange. It may be indicated by an initial cost, by a cost to reproduce, by a market price, or by reference to value of other economic resources that provide comparable services, and so on. And the question of the most appropriate value to use in various circumstances will involve very difficult areas of judgment, but we feel these difficulties must be faced eventually if financial statements are to be made more relevant and useful.

Under this concept, earnings should be considered a result of the measurement of economic resources and periodic earnings would be determined by the change in the owner's equity shown by comparative balance sheets, other than changes, of course, that result from distributions or additional investments from owners.

Perhaps more than any other statement, the statement

of income is used in assessing the future prospects of a business. Thus we believe it is important to highlight, for example, the impact of fixed expenses as an aid in evaluating the future with respect to volume fluctuations, to point out major gains or losses of an unusual nature, whether from regular operations or not, which may not occur frequently, and major expenditures made strictly for the purpose of creating future income benefits, such as for general research and development and major advertising, and designed to create intangibles, which in our view should be charged off as incurred. In addition, major holding gains or losses should be segregated from operating results.

Well, the approach we are advocating and an evaluation of how it might lead to greater progress in improving financial reports may be better understood by a very brief review of two key issues that may be the source of some of our difficulties.

There is, we believe, a confusion of cost as an objective rather than a method. And in looking back over the literature, it seemed to me that in the early part of this century cost was becoming regarded as a means by which information on value was conveyed. Cost was simply a dependable objective method to provide information on value. But the thinking gradually changed so that as accountants, in ever-increasing numbers, we proclaimed that we had nothing to do with values. Thus, while cost was originally considered as a means of conveying value information, it has now tended to become an objective or an end in itself. In the evolution, as you know, utility regulation, Supreme Court decisions which defined income

under the separability concept, the implementation of the Securities Acts, all have tended to elevate cost to the level of objective as opposed to a method of conveying value information.

And coincident with this solidifying of cost as an objective rather than a method of providing value information was the introduction of sort of a reverse approach to accounting measurement. The profession in the United States, as you recall, in the early 1930's began to suggest that balance sheets were not too useful and that asset valuations were not practical. The income account was emphasized as all important. This approach seemed to assume that earnings could be measured in a vacuum; that increases in wealth could be measured without measuring the wealth itself.

This emphasis and subsequent developments in the profession led to this broad and intricate network of methods and rules, all designed, in effect, to enforce the basic concept of allocation or matching of costs with revenues. Thus a major thrust of accounting in the last 35 years has been to measure earnings and plug the balance sheet with debits and credits as a result of the matching process rather than to measure the assets or the economic resources and obligations designating the net change in earnings. There are a number of examples of that that we could go into.

But this combination, we believe, of cost as an objective and reverse measurement is loading balance sheets to where they are little more than fluffy dreams of the future--

preoperating costs, development costs, advertising costs, general R&D, and so on--on the basis that these expenditures will be matched against future revenues even though they attach to no economic resource in which there can be a viable equity and certainly can have little meaning in any computation, for example, of debt-equity ratios.

Also as a result--and I think this is important--of a too rigid attachment to the cost matching approach, accountants have often resisted writedowns, for example, in plant and equipment for loss in value so long as they are in use. The major criticism, for example, as I recall, of Penn Central's accounting on the part of the ICC is that they had written down some railroad property and thereby relieved future income statements of depreciation charges.

So that the value approach actually is likely to result in more prudent financial statements in many cases than the cost approach and I think that it is important to remember that when we talk about current costs, current values, fair values, and so on, it isn't strictly a writeup process at all.

The objectives of financial statements, as we see them and which we have summarized briefly here, should lead accountants, we believe, to address themselves to current problems in a different fashion. Agreement on objectives will not necessarily make accounting any easier; it may make it more difficult but it should help assure meaningful and coordinated solutions.

Any useful objective should provide us, as accountants, with a basis for making choices. Whenever alternative account-

ing principles or procedures are being evaluated, there is a need to refer to the purpose of the accounting process. If value is selected as the goal, the basis for making choices exists. The accounting alternative believed to have the capability of producing the closest approximation of the best indicator of value should be preferred even if based essentially on cost data, given, of course, compliance with supplementary tests of feasibility and objectivity.

We believe that if there were agreement that the goal of accounting is to provide information on values and that even the cost approach is intended to do this, more meaningful solutions would be reached and perhaps some of the inadequacies in present financial reports would begin to disappear. The focus of the measurement process would be clarified and earnings would again come to be regarded as the result of the measurement of assets and liabilities and not vice versa. And whether many adjustments to cost are made or not, we really need a simple acknowledgment of the goal that, as we have previously stated, is even now intuitively felt, probably, by the majority of us.

Second, if agreement can be reached that the assets presented in the balance sheet should be limited to economic resources, as we have defined them, and should be presented on the basis of the most reasonably relevant value information available, progress could be achieved in dealing with many subjects, such as those relating to intangibles and deferred charges, even though the distinctions would be extremely

difficult.

But whether you agree with our view on those types of assets or not, we are sure that you will acknowledge that agreement on this issue, the criterion of asset admission is essential.

Third, the delineation of the accounting and investor function, we think, can also eliminate many confusions.

Regardless of the difficulties of measurement which may be encountered, mere acceptance of the objectives and goals could result in all of us working toward a common goal. Then we would have less rhetoric over uniformity and detailed rules and the exaggerated emphasis on the elimination of alternatives would be avoided.

MR. CATLETT: I might just make one general comment. I think part of the problem is what we are thinking about even when we talk about objectives. To me, what is so badly needed by the accounting profession is a compass and a North Pole to head toward. I think the accounting profession has constantly been running up a bunch of blind alleys. I think we have been reaching ad hoc decisions on problems without any general guidance. And the way I like to think about it is: In establishing objectives, we are trying to find a North Pole, we're trying to set our compass on that Pole which is our objective. We may never get to the North Pole, but that's maybe almost irrelevant.

The key question is: Where are we heading on a consistent, coordinated basis? This can change from time to time but at any one point in time we ought to know where we're

going; the accounting profession, in my view, has not known that and that is why we need objectives and that, of course, is why your Study Group is in existence.

CHAIRMAN TRUEBLOOD: Thank you very much, George and Norm. I'm going to break in just a minute before we start the questioning.

Dick Cyert was unable to be with us yesterday because of commencement at his university. Dick is an economist. He's presently Dean of the Graduate School of Industrial Administration at Carnegie. He is the incoming President of Carnegie-Mellon University in Pittsburgh and we're happy that he is going to have two full days with us even though we missed him yesterday.

Now, for a first question, Norm or George, I perhaps missed some refinements as you went along but you state that income should be predictive or income should be stated in such a way that it can be a predictive tool.

Now, my question is: If you indeed advocate that all expenditures made for noneconomic resource assets--and I presume that to be the intangibles such as human capital, R&D, and so on--if you advocate that they should be expensed, then aren't you impeding or impairing in some way the predictive qualities of the residual income?

MR. OLSON: Well, I suppose you could argue it both ways, Bob. I don't believe so because I believe that the accountant can't predict the values of expenditures for intangibles; it is solely dependent on earnings. And I don't see how any kind of capitalization can possibly help the investor--

the user--in predicting the future. I also think that all of the amortization techniques I have seen on that type of thing are completely arbitrary. They are not tied to any life at all.

I do think that in this kind of an approach to intangibles, and with the heavy emphasis on expenditures for intangibles these days in technology and other ways, that further disclosures than the mere segregation in the income statement are necessary. We are suggesting, for example--I didn't get into this in our notes--that perhaps there should be a statement of intangibles, particularly with companies heavily oriented in that direction, which could show not only expenditures on an annual basis but on a cumulative basis and maybe provide some information for the user on the amount of earnings being dedicated to future economic resources.

CHAIRMAN TRUEBLOOD: I have a second question also, this one from the floor, which relates to the same general subject. But I guess you did say, apart from a listing of intangibles as a supplemental statement, that there should be a further clarification within reported results of the nature of expenditures so that the residual income would be, in a sense, explained with the ups and downs of that kind of expenditure. Is that right?

MR. OLSON: That's right.

CHAIRMAN TRUEBLOOD: I think that's an answer to this question.

MR. CATLETT: I think we could say, Bob, that in this area the objective would be to disclose in the most meaningful

fashion what is being spent in the whole intangible area. Of course, there may be many different ways of doing that and more study and consideration should well be given to that; but there should be maximum disclosure in a manner that would be as useful as possible.

MR. GELLEIN: I'm sure I will have to read your paper to fully understand all of its implications, and I look forward to doing that, but I wonder if we could take a simple situation and see what it entails, using your notion of economic resources, finding this North Star, and heading toward it.

Let's take a simple case of a manufacturing concern that puts direct materials into the manufacturing process, applies some direct labor to it, and the product is part way down toward being finished. Now, how would you see the application of your notion to the determination of the value of that product, that inventory--work in process or finished goods, whichever it may be?

This of course, gets at the question of: What is income?

MR. OLSON: I want to emphasize again that our major point on value is to regard our cost process as a value informant. We have a section in the area of inventories. There are some difficult questions there. Basically, in most situations of goods manufactured to stock or goods held for resale, the present practice of FIFO or average cost conveys meaningful information. The risks of sale in that the part of the earnings process that's involved in the selling effort are so great that

valuing it at selling price is not justified.

I think that this approach, however, might give us a different answer on goods custom-manufactured under specific order where the selling risks and the credit risks have been evaluated before the earnings process. There should be no reason under those circumstances to delay profit recognition or to value finished custom-made goods at cost; those ought to be valued at realizable values.

LIFO valuation would disappear, for example, and this is where we feel that adopting the value attitude would tend to point us toward coordinated solutions.

MR. GELLEIN: It seems to me that you are just re-defining the realization concept.

MR. CATLETT: Exactly.

MR. PARKER: Would an example of this be a DC-10 aeroplane which has been ordered? Is that a custom type of manufacturing?

MR. CATLETT: When you get over into big items and long construction contracts pretty much made to order--either specifically to order or generally to order--you probably go to percentage of completion. That is what is being done now in some cases, of course.

MR. PARKER: Could I ask Norman a question in terms of the factory that makes the widgets that you were talking about? How does your value approach work there

MR. OLSON: As we mentioned briefly, and which we discussed quite extensively in our study, the concerns in the area

of fixed assets or plant and equipment and buildings these days should not be, or probably should not be, with undervaluation. I think that we need to be far more concerned, perhaps, as accountants than we have been with whether or not our depreciation formulas are adequate. Someone asked a question this morning about a 50-year life asset. The kind of technological changes that are occurring today and the kind of changes that are occurring socially and in markets makes you wonder whether anything should be depreciated over 50 years.

Hotels or buildings which are being depreciated over 40 years may be hard to justify. We may be living in plastic bubbles in ten years. I think the emphasis in plant and equipment should be on whether or not the assets are overstated and I think that's what the result could be from a solid value approach to accounting.

MR. PARKER: Suppose we take a steel company today. There it is with all its assets in place, some of them old, some of them new--more of them new than old. How do you, then, as the accountant or auditor, go at tackling the question of what kind of depreciation charge should be made.

MR. CATLETT: I agree with you that you can't generalize on things like that. I think you would have to study it.

We are suggesting a change. Norm and I suspect that we might have about as many writedowns as writeups if you really did what ought to be done today in a lot of cases. When you look at all the special charges that have been running through

the income statement in the last two or three years, you note that a lot of that is underdepreciation in the past.

MR. PARKER: What kind of tests or what kind of rationale would you run through in trying to decide, either in general or using the steel plant as an example if that's helpful?

MR. OLSON: Of course, in auditing we run through a lot of these tests now. We all intuitively worry about whether the assets are there. You look at the profitability, whether the plant is generating a profit. You ask questions about innovations, about plans for replacement, to determine, first of all, whether the assets are worth what they are now carried at.

I think if you get into a situation where you have got a healthy plant turning out a great product and good profits that's fully depreciated we ought to stop and establish some reasonable value on it so we can get a legitimate depreciation charge. That's the kind of an effort that now is generally not made on the basis that the costs have been matched and allocated against profits. I think the value attitude would in those extreme cases restore the plant and equipment under some formula and it probably would be under some depreciated replacement cost kind of basis.

MR. CATLETT: Let me give you a concrete example; some people in the room will recognize it.

Several years ago our firm was auditing a meat packing plant. They had a large plant that was not very successful

in its current operation. They had a labor contract with very high termination pay; the termination pay requirements were so large that they couldn't afford to shut it down. They offered to give it to the city, or anybody else who would take it for nothing, literally, and take over the labor contract; nobody would take it for nothing.

This company wrote it down substantially. We certified it and several prominent accountants jumped all over us under the logic that as long as it was in operation we did not have the right to write it down because we were relieving future income statements of the depreciation charge, when the darned thing wasn't worth anything.

That is what we are talking about, changing that emphasis away from matching depreciation with revenues just because you are using it. They offered to give it away to anybody who would take it and there wasn't a single taker. I think under those conditions the value was zero and it should have been written down. I don't care whether they were operating it or not.

CHAIRMAN TRUEBLOOD: Let me pick up Reed's question about the steel plant in a different context. I kind of think I know what your answer will be. Given this steel plant such as we have all over the place in the South Side in Chicago, whether it be new or old, it is a polluter. This is presently illegal or prospectively illegal. That plant is not going to be operable within our time span in the same manner as your glass bubble.

I presume your theory would be that, with or without present statute, even though the plant is presently operational, that required rejection of the facility should be presently recognized.

MR. OLSON: Yes, it should be a consideration in the valuation and depreciation practices applied to that plant. I'm not familiar with the steel industry at all there, with that particular problem or how imminent it is, Bob, but given those facts, this is true.

I gather the auto industry faces the same problem in meeting the ignition standards of a number of states. Certainly it's a consideration that managements and accountants should take into account in depreciation practice.

DEAN CYERT: Do you think that your theory holds equally well in a period of falling prices? One thing that worries me is that current conditions are influencing thought in this area to the point where we're sort of deluding ourselves and thinking we're getting at the truth and what we are really doing is reacting to the situation.

For example, suppose in a period of falling prices the firm has positive earnings, as we would now define it, but not great enough to make up for the loss of current value. Would you say that it could be accurate to say that that firm is making a loss or has zero earnings?

In other words, think through your position under opposite conditions.

MR. OLSON: There's no question that the value approach cuts both ways, up and down, and I would reemphasize again that I think the value approach, if administered with integrity may produce more writedowns than it will writeups, even under today's conditions.

DEAN CYERT: Don't you think that's misleading? I mean that, in a sense, one of the things we are trying to measure is the performance of a particular system of machines and managers, and those machines and managers may be performing well, but something else is happening in the society which is affecting the particular values.

What is it that we are really trying to measure? Are we really trying just to reflect what society is saying in general or are we trying to measure the particular enterprise?

MR. CATLETT: To me, we're trying to reflect the facts and, of course, there's a great deal of judgment in this area you're talking about. You have short-range trends and long-range trends. I think you have got to analyze each case and use your judgment.

There may be areas such as a series of computers that are going to be obsoleted by another series of computers. You can have things like steel mills that may get to the point where you can't even operate them any more. It just seems to me that you have to evaluate all these factors; you are not going to be writing plants up and down every month and that sort of thing. You have got to take more long-range factors into consideration.

But if you have a high degree of evidence that in five years it's not going to be worth anything, you have got to take it into account; that's more in line with what we are talking about than plants going up and down.

And when you get over into marketable securities, such as a thousand shares of General Motors, and you go to market value, that's a lot different than a steel mill, I think. You would tend to go up and down more there, I think.

DEAN CYERT: It seems to me there you are contradicting one of the points that you made earlier, when argued that it wasn't the accountant's function to begin to predict the future, because now you are predicting the future in terms of trying to value this particular asset.

MR. OLSON: Let me go back to your earlier question. I'm not sure that I grasped the thrust of it, but, basically, the income statement would separate holding gains and losses. And I would envision that if you did have a writeup for example, in plant and equipment, you would then have a higher charge against operations for depreciation. Similarly, if you should have a writedown, you would have a lower charge against operations. The operating results would still be carved out separately albeit they would reflect from a depreciation standpoint any changes in value.

I think this touches a little bit on the question that someone asked Larry Vance earlier and maybe this is also partially what you are driving at. As far as accountability is concerned, it's difficult for me to say how you can establish

any real accountability insofar as management is concerned unless you charge them with some reasonable measure of value of the resources they take over. A management, for example, that takes over a company that's got a \$200 million unrecorded profit in marketable securities can show profits of \$100 million and may-be lose \$100 million. There is no accountability without it--no real accountability, it seems to me, without that approach.

CHAIRMAN TRUEBLOOD: Aren't you really asking the question, Dick, as to whether the change in value resulting from falling price levels would be reflected as a holding loss in this valuation process?

DEAN CYERT: Yes.

MR. CATLETT: I think you would but some things might be reflected faster than others by the nature of them.

CHAIRMAN TRUEBLOOD: So you would tend to hold operating results separate and therefore you would have a continuing thing.

Sid Davidson is next, I believe, if you still wish to ask a question.

DEAN DAVIDSON: Yes. Well you know, it's all right for you practitioners to be visionary in this regard but we academics have to be concerned with the problems of implementation.

I'm kind of worried about whether this system would envisage the continuation of unit property records and what would be the clues. If the answer to that is yes, what would be the clue for change in the valuation attached to units of

property and who would make this revaluation?

I think I'm wholeheartedly in accord with your objectives but I'm not quite clear how we'd move in that direction.

MR. CATLETT: I think there are two aspects of this. One is, we have to first decide whether it's desirable to move in this direction. That's the first question. We are concerned about implementation also but you do have to first decide whether you want to go in a certain direction; and if it isn't desirable, it doesn't make any difference about the implementation. We at least, have concluded that it's desirable to go in this direction where there are significant departures.

In a lot of areas of plant and equipment and inventories and things the departure wouldn't be sufficient to do it; but you are talking about the cases where it would be. And wherever there are significant departures, either up or down, based on all the facts, adjustments would be made.

We aren't going to be able, as you well know, to sit here this morning and say exactly how we're going to do all this vast array of things. You have got thousands and thousands of companies and hundreds of industries and a great variety of circumstances and we feel that it's feasible to approach the facts in each case and use your judgment as long as we know what we're trying to accomplish.

At times you might use price-level indexes; at times you'd use other things. I don't think, myself, that it's possible to have any one approach to valuation when you have got such a huge variety of circumstances. I think if we know what

we are trying to accomplish, then you probably would end up using eight or ten or twelve different approaches and overriding your whole thing is your evaluation of the facts anyhow.

Whether a computer that's not in use is going to be obsoleted three or four or five years from now becomes a highly judgmental matter. But you do have to use judgment and managements have to all the time; auditors are forced to and that's why we have a profession. If it was easy, all we'd need to be is bookkeepers.

DEAN DAVIDSON: Yes, but I guess you might run into the attitude that the use of values of economic resources as a means of controlling our recordkeeping is desirable, if attainable.

MR. CATLETT: Right, and we should do it to the extent it's attainable.

DEAN DAVIDSON: Sure.

MR. CATLETT: We're setting objectives here and we're assuming that we are going to take steps in that direction on a controlled basis to the extent feasible and practical and if we can figure out where we want to go, maybe we'll address ourselves more to arriving at techniques and ways and means of getting there.

The trouble with the conversations so far is that they haven't even decided they want to go in that direction and therefore they haven't even seriously considered the problem; I just won't accept the fact that it's impossible to do if it's a good idea to do it.

MR. PARKER: I just wanted to follow Sidney's question a little bit; I think it's a good one.

You said a little while ago that if you had a plant

that was all written off and was still obviously humming along, producing fine profit at good margins, there ought to be some way to write that plant back up and start depreciating again; and I suppose there would be the converse.

But just at about what point do you think you begin to cut in? Would you say somewhere between minus two percent rate of return and a plus ten percent rate of return we leave the valuation alone and flow on the depreciation like we used to; get outside those parameters, and we think it's enough to trigger valuation. Would you apply that kind of a technique?

MR. OLSON: Well, I really think, Reed, it's pretty impossible to generalize in that kind of an area. We're making those kinds of judgments now, every day. There's a lot of instinct there; there's a lot that goes with knowing the company and knowing its product and knowing its plans. And I have sensed from years of experience in this field that if you know your client, you get a pretty good feel as to whether they are being too short or too long on their depreciation lives.

It's a very, very judgmental area and I don't think it's possible to reduce it to any precise formula.

MR. GELLEIN: I was going to ask a little different sort of question of George and Norm. It will take a long time to get to the North Star, I suspect.

MR. CATLETT: You may never get there.

MR. GELLEIN: My question really is this, George, that this becomes a very long-range goal and of course generations of investors and other users may come and go before we attain

those long-range goals. Do you have any views that you could express now that would help us set the mid-range goals and the short-range goals within that framework?

MR. CATLETT: That's great, I think it is an important point. I want to comment and maybe Norm will too.

We aren't talking about short-range, middle-range, long-range or anything else. When you put a compass on the North Star, you don't have degrees of getting there. What we need to decide is where we want to go and we may never reach the ultimate in all respects but it ought to guide us tomorrow, next week, next month, on every decision we make.

And the point is, as we take our steps, tomorrow the first step--it's like everything the accounting profession addresses itself to in this area. If we've decided where we want to go, we ought to say which of the alternative solutions best goes in the direction we want to go; this will apply every day and to every decision.

That's the point. It isn't any question of steps or anything else.

As far as I'm concerned, the main justification I have felt, for the equity method of accounting--this isn't what the opinion says--but in my own mind the main justification for equity accounting was that it was a step closer to value accounting and that's all. We do it because it's controlled. You can audit some numbers and so forth. But it's closer to value than cost is. And I think you can say that of a lot of other things.

If you can agree on goals of this type--whether it's this goal or some other goal--there ought to be guides in every single decision. We don't mean a whole big framework of accounting theory; this may be four or five things. If you have laid those down and agreed on them, you say: Which one of the four alternatives best meets the goal? That won't be so hard to decide. And that settles it and you don't spend two or three years arguing about it.

CHAIRMAN TRUEBLOOD: So the short-range, long-range dichotomy comes more on the implementation side than on the statement of goals or objectives.

MR. CATLETT: It guides every step.

MR. OLSON: I think it could affect the individual decisions, and I would be opposed to designating any period of transition. I think when you are talking goals and objectives, the profession, in particular, is always in a state of transition.

MR. WESTON: I was interested in your exclusion, basically, from your definition of economic resources of many intangibles. If your goal is to measure wealth of entities and your three criteria are utility, scarcity, and exchangeability, I guess it's the latter one which causes the problem. Did you eliminate things like trade names and good will and some of the things that make some of our large corporations very valuable in the sense of economic wealth these days? Did you eliminate those because of the difficulty of measurement?

MR. OLSON: Yes, in general, Frank. The concept of exchangeability and separability is a difficult one and the

distinctions will be difficult; I don't know that you can just say that R&D is all one. There are different types and I think there could be different answers under different circumstances if we want to get into that.

Basically, as I said or tried to say, the intangible attributes that you really cannot provide information about as to value in the balance sheet may be more valuable than the economic resources in which there can be viable equity and which are more or less bankable and have some meaning in the balance sheet.

The point is that we feel that the only information we can provide the investor and other users about the elements of wealth that do not meet the standards of an economic resource is to provide him the best information we can about earnings. Earnings and profits are what indicate the existence of those attributes.

Then it becomes the investor's function to place a value on those when he values the business as a whole in the marketplace. This is why we feel it's important not to interject those into the balance sheet because we don't feel you can really convey any meaningful information on the cost basis, or any other basis, as to their value.

Now, that may be true of some economic resources too, at times.

MR. CATLETT: Another way of saying that, Frank, is that the cost of many of these things has nothing to do with the value, as you know. There's no relationship between cost

and value when you get into the intangible area. You might spend \$1,000 and find something worth one million.

And in many companies, as you know, the marketing organization, the research organization, the management ability, and all those things are really the most valuable thing that the company may have but you can't put dollar signs on those things.

MR. WESTON: Well, I'm a little disturbed, I guess conceptually. Reed's plant which is turning out widgets at a great profit rate may be a terrible plant, overvalued and very inefficient, and the reason they are making money is because they have some very valuable intangibles which aren't on the balance sheet; your financial statements, therefore, not only don't show the proper wealth of the entity, they are misleading in at least two major areas.

MR. OLSON: We feel that the profits speak for themselves with the investor, Frank, and tell the investor about the existence of the intangibles.

MR. WESTON: I know, but your articulated statement, the balance sheet, shows assets that aren't contributing to those earnings and does not show the principal assets which contribute to them.

MR. CATLETT: Yes, but I would ask you what you would do because the cost has got absolutely nothing to do with the value of what you are talking about. Are you talking about capitalizing the market value of the stock and putting it on the balance sheet?

MR. WESTON: Oh, no. I'm saying that each of the

economic resources of an entity, if you go to the value route, should be in the balance sheet. To pick out the ones that are exchangeable or separable, as your idea does, may get an entirely misleading and wrong answer which supports earnings with values that aren't there and doesn't show the real values that are there.

MR. CATLETT: Yes, but the value, Frank, of good will, management research, marketing, and all that sort of thing has nothing to do with the cost expenditures anyhow...

MR. WESTON: Exactly!

MR. CATLETT:and the only way you could put that on would be to capitalize the earnings and put the market value of the stock on the balance sheet and everybody would show a normal rate of return; that's the circular reasoning that Norm talked about, which couldn't serve anybody.

MR. WESTON: But that is, in fact, showing the wealth of that entity which I thought was your primary goal.

MR. CATLETT: No, it is not our goal because we are not trying to equate the balance sheet with the market value of the stock.

MR. WESTON: No. I know.

MR. CATLETT: And otherwise, there's no way of getting it on anyhow unless you put the market value of the stock on.

MR. WESTON: The market value of the stock is something else. That's in the marketplace. But the assets and the wealth of the entity do include these intangibles which you are excluding from the balance sheet.

MR. CATLETT: We think they have no place there.

MR. WESTON: The trade name, the proprietary drug abilities, the contracts with executives, and so on are, in fact, resources; they are wealth. But they wouldn't be in the balance sheet, as I gather your value proposal.

MR. CATLETT: Right. We don't think they have any place there. They are valuable. In fact, in a company like IBM they may be more valuable than what is there; but we don't think it's the purpose of financial statements to capitalize that.

MR. WESTON: I'm troubled by the approach that you have selected--relatively speaking, to value the resource is easy. You say those will be in the balance sheet; the difficult ones won't. And my point is that you end up with a hodgepodge which maybe is really meaningless.

CHAIRMAN TRUEBLOOD: I think this exchange pretty largely takes care of one of the questions from the floor and we must finish up and have a short break here. The same point was made from the floor, that if cost is a reasonable proxy or an initial indication of value in the case of fixed assets, why is it not in the case of intangibles?

But it seems to me from your earlier presentation that this leads into another question from the floor, which in effect says: Are you stating that where the degree of subjectivity and uncertainty is large, we must rely on extended disclosure as in the manner of listing of intangibles, and so on? Is that your suggestion?

MR. OLSON: I think that's partly right. More pre-

cisely, I would say we have tried to define assets, using the term "economic resources," as those which do possess some value not completely dependent on the fortunes of the particular company involved. But we would add that there may be some items that meet the test of economic resource--and we discussed this some in our study--for which just out of sheer immeasurability, certain patterns, for example, no useful information as to value, whether on cost or any other basis, can be conveyed in the balance sheet. I think with those elements of wealth all accountants can do is provide information on profits and then the investor places a value on it.

Getting back to your point just briefly, Frank, take the illustration of a public accounting firm; many of us are familiar with them. I suppose that, certainly, the real wealth of Arthur Young or Arthur Andersen has to be in the competence of its people. But isn't it the translation of the competence of its people into assets that constitutes the earnings process? And could you really help a banker or help a partner in a firm by trying to show him what the costs of recruiting and training are in the balance sheet and then amortize this over some turnover figure?

I think every partner in the firm and every banker would take it off to get at the facts. The profits, or the success, or the growth of the firm speaks for the wealth of its people and I don't think there is any other way for accountants to convey that information.

CHAIRMAN TRUEBLOOD: Thank you very much, Norm and

George. We do look forward very much to your presentation in the next several weeks and I know it will be extremely helpful.

I want also to publicly thank your firm for the very valuable services of Mike Shannon on a full-time basis. He's been a great help and has made a significant contribution to the work of this group. Thank you.

We're going to proceed with the Financial Executive Institute, represented by J. O. Edwards.

Would you indicate the nature of your committee structure, J.O.?

MR. J. O. EDWARDS: We have a Corporate Reporting Committee of which I'm the Chairman; the Corporate Reporting Committee deals in the accounting issues that the APB deals in and has its contacts with members and subcommittees of the Accounting Principles Board.

I'm very pleased to be here this morning and the Financial Executives Institute does indeed welcome the opportunity to offer its views to your Study Group. Your endeavor is one of equal importance with that of the Wheat Committee and in some respects is more fundamental. One might even speculate that had all of us had from the beginning a common understanding of the purposes and objectives of financial statements, the formation of the Wheat Committee might not have been necessary.

Be that as it may, financial executives everywhere will have a vital interest in your findings since we will have to place into effect, be responsible for, and, hopefully, be-

lieve in whatever you recommend. Further, we are probably about as weary as you must be of the lack of agreement on the conceptual framework which must be present if we are to resolve some important but controversial accounting issues such as leasing, research and development, extraordinary items, marketable securities, and extractive industries, to name a few. We hope this will be the major thrust of your efforts, as noted in the written statement we filed with you in February, and we acknowledge an obligation to do everything possible to help you in this task.

I will attempt only to highlight our preliminary statement and perhaps give it a more up-to-date perspective.

First, we support the objectives contained in Accounting Principles Board Statement No. 4, that the emphasis on general purpose information in accounting is based on the presumption that the information needs of a significant number of users are similar and that the acceptance of one approach requires the rejection of other approaches. We hope you will agree with the validity of this presumption while recognizing the additional need for special purpose statements. Resolution of this question is critical if we are to agree on the identity of the primary users. F. E. I. believes that the primary users are stockholders, existing or prospective, and creditors, and that the published financial data that can be most useful to these users should be that which flows naturally from accounting data needed by the management to operate the business. Accordingly, F. E. I. believes that the primary purpose of financial statements of

a business enterprise are to discharge management's obligation to report on how it has used the resources of the business in its profit-directed activities and whether it has operated successfully or unsuccessfully. You may call that stewardship if you wish, but we frankly do not know of a better place to start in providing the investing public with meaningful and useful information for the assessment of past performance.

Whatever we may do to supplement existing reporting procedures, we hope nothing will be done to deny users the kind of basic and objective performance data which to us should rank highest on the scale of usefulness. For the present, we do not believe that the desirability of retaining the basic financial statements as the core of corporate financial reporting will be seriously challenged. We do not mean to imply that your study will not result in substantive proposals, but rather that these proposals will be in the area of supplementing, expanding and modifying the existing system of presenting financial information. Fundamental changes in accounting must of necessity be evolutionary if we are to avoid chaos in reporting. Accordingly, we believe that cooperative efforts should continuously assess the desirability of developing new systems of accumulating, using, and reporting financial accounting data.

Now, admittedly, financial executives are cautious about embracing reporting innovations. We believe CPAs and users should be also. We are trained to ask why, especially how, and, above all, to seek justifications. Financial management has serious responsibilities to both its corporate manage-

ment and to all users of financial statements. Responsibility engenders a reluctance to accept sweeping changes that have not been tested. We submit there is room, indeed, an important need, for honest dissent, a need to withhold acceptance, and a need to maintain the continuity of existing systems until new proposals can meet the criteria of practical application and general acceptance. The profits and other data reported in published financial statements are critical to the reporting unit and to its stockholder owners. Management's objectives and strategies for years to come are based on its reporting methods and accounting policies. Management resists changes in statement content and accounting procedures advocated by those not in the firing line that can substantially affect reported earnings.

As your Study Group fully appreciates, accounting and financial reporting are not subject to natural laws and relationships similar to those which must be observed to obtain the correct solution to a problem in the physical sciences. Accounting employs basic philosophical principles, theorems, and postulates which, when applied with judgment, produce a system designed to classify, to measure, and to account for the multitude of events and transactions which occur day-to-day throughout business operations. Accounting cannot operate without estimates and judgment. There can be no fair presentation of operating results in financial reporting without experience and a knowledge of the facts, the underlying circumstances and the substance of the transactions, as well as an understanding of the philosophies, plans, and objectives of the business. Accordingly,

any proposal to change or displace existing practice must be challenged until the impact of the proposed change can be evaluated.

It is for these reasons that we support the stewardship and historical cost concepts.

We believe F. E. I. reflects the attitude of its members in a commitment to the concept of full disclosure of financial information whenever such data would be meaningful, have a material bearing on the results reported, and not be misleading to the investing public. Our commitment, however, recognizes that the term "full disclosure" has not been adequately defined and that the achievement of the concept requires the assistance of all interested parties. We suggest that continuing demands for additional information can be self-defeating in that meaningful information becomes hidden in a mountain of minutiae and that this may be a poor substitute for responsible efforts to identify financial reporting objectives.

In our opinion, management will react quite favorably to proposals to improve financial reports when the need for the change and the methods of applying it in practice are reasonably demonstrated. Some proposals and changes appear to management to lessen the professional responsibility of financial officers and public accounting firms. Your Study Group has a great opportunity to make substantial contributions to the identification and understanding of objectives and to facilitate the establishment of guidelines for improving accounting and financial reporting so that reports become more understand-

able to the lay reader as well as the professional. And we are confident your study will also consider the balance between the need for change and the effects of material changes on credibility.

In this connection we urge the Study Group to consider current and past accounting research efforts provided by various organizations, including the Financial Executives Research Foundation studies on "Financial Reporting by Diversified Companies;" "The Effects of Circumstances on the Application of Accounting Principles;" "The Concept of Current Value Reporting;" "The Concept of Materiality;" "The Feasibility and Legal Implication of Publishing Earnings Forecasts and Other Future Events;" and others which have a bearing on the areas covered in your public hearings.

With respect to publishing earnings forecasts, F.E.I. believes that the prevailing management view probably is that the degree of accuracy required for reporting such data to the public has not yet been achieved. Business forecasts and operating budgets are important tools that management uses in planning and administering the business; they are guidelines toward a common goal; they enable management by exception, in that they are primarily road maps which permit management to act and react to unforeseen or uncontrollable events which would otherwise have a more serious impact on operations. Aside from the complex questions regarding the validity of the underlying assumptions, the competitive disadvantages of disclosing operating plans and strategies, legal liabilities, et cetera, there are serious res-

ervations as to the usefulness of these data in estimating future values and stock market prices.

With respect to the applicability of historical cost versus current values in financial reports, F. E. I. believes that historical cost accounting has generally been adequate in the past as the basic method of measurement. We do, however, recognize that alternative bases for valuation must be reported whenever such information is meaningful and material to the users of financial statements. Given the present state of development of alternatives, historical cost accounting is now the best available method for primary use in statements. We are studying the feasibility of using alternative methods in the light of stockholder needs and management's legal and ethical responsibilities for full disclosure.

Our Research Foundation has contracted, as you know, with Booz, Allen & Hamilton to conduct a study which is designed to develop a total understanding of the businessman's viewpoint of corporate reporting in terms of the purpose and objectives of financial statements. The study will include consideration of the uses, needs and rights of users for various types of information and the implications of providing such additional information as is currently being advocated by various interested parties. The primary emphasis in the FERF Study is on the views of preparers of financial statements; whereas we realize your research has given attention primarily to financial statement users. Thus, our study will, we hope, complement rather than parallel the work of your Study Group.

In another important area, we believe that the question of the degree to which corporate financial statements can validly support attempts to compare the operating results and performance of different companies is highly relevant to this Study Group's efforts. The subject of intercompany comparisons has long been debated without definitive results to date. Our position is that the consistent application of accounting principles and related disclosures thereto provide the user with the best known means to compare the financial statements of a particular business enterprise over time. Even here, comparability is so affected by changes in business operations that results have to be restated and analyzed in depth to understand the degrees of comparability between years.

There are no accounting principles or rules which can provide any assurance with regard to attempts to compare different companies. Regardless of the existence of "Uniform Account" systems and the desire for easy comparisons of the financial statements of different companies, we believe that such comparisons are not really feasible because no two companies are comparable. We suggest that financial analysts and others recognize that accounting can only record facts that have occurred within a company and can only be comparable to those of other companies if the facts are comparable. Appropriate reliance has to be placed on nonaccounting information and professional judgment to supplement evaluation of reported financial results.

In closing I would like to refer to your Study Group charter and attempt to summarize our answers to the key ques-

tions you are asking yourselves:

First, who needs financial statements?

Our answer is that there are many diverse users who need financial statements but in order to resolve accounting controversy we must come to grips with the fact there are primary and secondary users and that general purpose statements should be oriented to the requirements of stockholder owners, existing and prospective, including their advisors, as well as creditors. Requirements of special users can be served by special statements.

Second, what information do they need?

They need information that will help them evaluate how well the management has utilized the resources committed to its deployment and the success, or lack thereof, of its profit-oriented endeavors. The quality of the information should have as many desirable characteristics as possible, not the least of which are objectivity, verifiability, and understandability. These requirements heavily favor historical costs over value although supplemental value information may in time assume a larger role.

Third, how much of the needed information can be provided by accounting?

This may be the most important question of any for it forces us to face up to the limitations as well as the capabilities of accounting. Our answer must be only a relatively limited part. There may be another word that should be added when we speak of the purposes and objectives of financial statements and

that word is "potentialities." Given the existing state of the art, what potential do financial statements have to prompt investors to buy or sell? We know you understand, as we do, that the investment decision is a mix of many assumptions and imponderables but the frailty of the underlying assumptions is often so great as to suggest that we should eschew any reporting system that purports to provide high-level quantification of the decision for the investor as the leading or primary goal of financial statements.

Fourth, what framework is required to provide the needed information?

The framework required is the existing series of statements, including the income statement, balance sheet, shareholder equity, and flow of funds statements. The framework should continue to be anchored in historical costs and completed transactions.

Value determination, forecasts, and long-range projections must have a secondary role and should be approached with caution. Segment reporting should be employed to the extent it is meaningful.

As a final observation, let me say candidly that in the beginning F. E. I. members were concerned that your Study objectives might be too all-encompassing. But now I think we realize that you had to start out with a broad scope to make certain that no improvement opportunities are overlooked. Since the main purpose of your Study is to "refine the objectives of financial statements," we hope our comments will help

you come forth with a more commonly understood and agreed to blueprint for the resolution of accounting controversy.

CHAIRMAN TRUEBLOOD: Thank you very much, J. O., and we certainly do appreciate your considerable help on the research side. You have not only completed but have in process a number of major pieces of research which fit directly, or at least closely, to our interests, and your giving them to us on an "advanced" basis, as it were, has been extremely helpful and will save us a great deal of time.

I'd like to tackle first the question of disclosure. It's my recollection in the early part of the paper that you put considerable emphasis on disclosure, not as a substitute, but as a help towards the information process. You gave some concern about its tendency to lead to minutiae, but particularly in relation to our conversations yesterday--and I believe you were not here---

MR. EDWARDS: No, I was not.

CHAIRMAN TRUEBLOOD: There were two questions which sort of recurred, or were inferred by some of the witnesses, both relating explicitly to the disclosure problem. One is: What is the real, true, fair line in the disclosure of competitive data? I mean, how do you establish amongst yourselves what cannot be disclosed for proprietary reasons and should be disclosed for the good of the potential or actual investor?

The second question is very closely related. In terms of corporate information, what is a private good and what is a public good--"good" in the sense of "right to know"? Would you

care to comment on that?

MR. EDWARDS: Yes. The first question is: What can be disclosed without harm to the business?

As you know, or probably know, the F. E. I. position is that we should encourage segment reporting. We should in all cases report where there are different business lines with different elements of risk and, in effect, different types of business. But we also say that the competitive question, the matter of potential disadvantage, is a significant one, and that in the last analysis this has to be reserved to the judgment of the management because they in the last analysis are responsible for anything that might harm the enterprise to the advantage of competition.

Maybe we have a tendency to overwork this but it is a valid, very critical point, I think, and we don't really have any way to provide any guidelines other than that it is a matter of judgment. We're encouraging more of it. We see more of it. I think the trend is to make more segment disclosure; but I don't think there is any question that there is proprietary information and I don't just mean secret processes either. Management may have knowledge of things that the competition doesn't have and in order for them to discharge their responsibility, if it means not disclosing it, then they have to hold it back.

The second question refers to the corporate information, that is the contrast between the public need as opposed to the--

CHAIRMAN TRUEBLOOD: The public right as opposed to the private need.

MR. EDWARDS: I think that we see a difference between a right and a need. I think we see the right as being those who are owners or prospective owners. The need are those who have reasons other than investment objectives.

But we think that the requirements for those mentioned in my comments, the secondary group, have to be subordinated to the requirements of those who have the right and the obligation and the responsibility as owners of the business.

And so you walk a tight line here, but nevertheless, I think that the primary thrust of what we do in this field of objectives of accounting statements has to be those who have the right. I think if we make an effort to roll all those into one set of objectives and standards, then I think we are maybe going to cause a little more confusion than we have already got. I guess when it comes into the area of need, as businessmen, we feel that we should all be coming forward in this area to disclose everything that we think is meaningful that can be disclosed but we realize also that there is a role of government in this from time to time, and as we go along, and that much of the secondary need for information will inevitably be defined by government. We're not sure that's all bad, if it is that way.

CHAIRMAN TRUEBLOOD: It's not particularly applicable to the industry in which you are currently involved but as reported in The New York Times this morning, Don Etra, of the

Nader Group, took a strong position in relation to the automobile industry that, whereas it is customary to report only significant lawsuits, there really should be an ongoing reporting to the public of warranty claims or performance complaints, and that sort of thing, which is going a very far way from what has been customary on the industry side.

MR. EDWARDS: True. I'm not in the motors business, as you know. But if there is a need, and a real need, it would seem to me that would come from some government-requested or government-encouraged directive. If the warranties don't have a material impact on the financial picture of the motor companies, then I think that would contribute minutiae.

DEAN DAVIDSON: J. O., I'd like to go back to page 3 of your prepared document, where you expressed the view that the primary purpose of financial statements is to report on how management has used the resources entrusted to them; of course, because we are quantitatively oriented, I suppose we have to place a valuation upon those resources and it is with regard to that valuation that I would like to inquire.

Assume we have two firms set up in two different lines of business five years ago. Both invested the same number of dollars in their resources and both have the same expected service life, but in the one case conditions have changed and reproduction costs or current values of those resources have gone down substantially and in the other case conditions have changed and reproduction costs or current value of those resources have gone up very much.

Both of these companies in Year 6 report the same income--the same dollar income--based upon our conventional methods, and we relate that to their resources and they both seem to show the same rate of return. Do you think both managements have performed as effectively in Year 6?

MR. EDWARDS: I guess I'd have to know why, in the case you gave, Sid, the reproduction cost in one case went down and in the other case it went up.

DEAN DAVIDSON: Technological advancements. I guess it's true that it takes less capital investment per kilowatt hour of electric power generated today than it ever has in history, despite rising prices, whereas probably to turn out a gallon of gasoline requires rather more capital expenditure than it did before.

MR. EDWARDS: Given the example, I guess you are saying that if one of them didn't keep up with technology, and re-invest in the five-year period---

DEAN DAVIDSON: No, just the cost of providing capacity has gone down in one field and it's gone up in the other.

MR. EDWARDS: Oh, those are different types of industries.

DEAN DAVIDSON: Oh, yes. Right! They are in different industries.

MR. EDWARDS: I think that's kind of an unusual situation but if you have that occur in a five-year time frame, then I think that this is one of those area where people like Mr. Parker over here are going to know what's going on in this

case where the industry did not keep up in the technology and I think that information is going to be made available.

Now, the Aunt Janes--there isn't any way they can---

DEAN DAVIDSON: But, J. O., I'm going to what you describe as the primary purpose, and that is management's obligation to report on how it has used the resources; if the value of the resources in one area has gone down, and the value in the other has gone up, does management have an obligation to relate to the numerator of earnings that denominator of the resources entrusted to them in value terms?

MR. EDWARDS: I really don't think so, Sid.

CHAIRMAN TRUEBLOOD: Can I just go one step further? And then I'll get to you, Reed.

Isn't there another piece of this? It's probably wrapped up in Sid's question but on that same page you take the position that stewardship is your primary responsibility. Whether the change in value comes from the technological misuse or imaginative use, does not stewardship also contemplate a reporting on changing values?

MR. EDWARDS: I think, as we said in our comments here, it's conceivable that some time in the future it could involve both some kind of reporting on changing values as well as what has happened to the cost basis of the resources committed to the management. To clarify a bit, as an investor, if I had to choose--and I'm not suggesting you should have to choose--maybe at some point in time the investor can get both, but if you give me my choice as to which I would want in all cases as my leading set of data, I would take what's been done with the mix of costs that have gone into the business over that past

five years.

I'm not suggesting that reproduction cost value, or price level adjusted statements might not have some value to an investor. I'm questioning the need for that kind of thing to supplant historical costs; I'm assuming that one of them has to be the leading system and that's why I think we come out where we do on values.

CHAIRMAN TRUEBLOOD: If you were operating in Brazil, would you take a different position?

MR. EDWARDS: Yes, I think we would.

MR. PARKER: Mr. Edwards, noting your statement on page 12, where you say that accounting can only record facts that have occurred within a company and can only be comparable to those of other companies if the facts are exactly comparable-- in an early part of your statement you indicated that you felt the primary purpose or use of these financial statements ought to be to serve the stockholder or the creditor. I think we have an ample presentation from other papers, including that of the Analysts Federation, that one of the primary needs of the stockholder--user is information that will aid in the comparison of one company with another. You say they can't be compared, except on identical facts, but this is what the investor has to spend most of his time trying to do, and, of course, he does, in fact, compare dividend payments. He does, in fact, compare rates of change in earnings. And to the extent those reflect different kinds of accounting policies, even for transactions

that aren't exactly the same, but are anywhere near close to being the same, doesn't this insistence that you mustn't have, or you shouldn't look for, fairly comparable accounting policies, come in conflict with a basic investor need?

We take, well known examples like the investment tax credit, move to the famous one of the computers that sometimes have five year lives for one company and ten years for another, accelerated versus straight line depreciation, where you are using, maybe, identical lives, but quite different methods, these have quite enormous impact.

Or take another one, the DC-10 versus 747: One company writes off the research and development as incurred and the other writes it off over the production life of the plane.

Do you really feel that companies have a right, if they are really going to serve the stockholder, to insist that there's no reason for comparability of accounting techniques unless you have exactly comparable facts?

MR. EDWARDS: I don't know. The word "exactly" may be an overstatement of our views on this subject but I think that what we are suggesting is that there has to be some kind of a rule of reason and that the thought that uniformity is going to give the investor a clearer determination of what he can do with the data and how he can compare one company with another, unless he understands what facts and circumstances this uniform accounting system has been applied to, is going to do him more harm than it will good. It's going to mislead him because he's going to think something is comparable that's

not comparable.

I think we make a distinction between comparability and uniformity. Certainly there must be comparison and there should be every effort made to eliminate undesirable and unjustifiable alternatives; but, then, I think, as our research project headed by Bob Mautz--I think he was here yesterday, was he not?...

CHAIRMAN TRUEBLOOD: This morning as well, for a while.

MR. EDWARDS: ...indicates that we feel that uniform accounting systems are not the end-all because I just don't believe uniform accounting systems where they have been applied, have done that much for the investor.

MR. PARKER: Yes, but, of course, uniformity and flexibility have been argued for a long time and obviously the outer extreme of either one is not going to work.

MR EDWARDS: Right.

MR. PARKER: We'd agree on that so we're always going to be faced finally with: In what part of the spectrum ought one to reach one way or the other?

And I'd be interested in your view. As it's said here in the paper--"exactly comparable"--that you'd be way off on the right hand end, complete flexibility. How much tradeoff ought you be willing to go through to help this stockholder that you are working for?

MR. EDWARDS: I think what we really were intending to imply here is that you can't take the information on the two companies and make an intelligent judgment that the facts indi-

cate that you should sell one or buy the other, based on that information alone, unless you have determined that the facts underlying the information are the same.

MR. PARKER: Well, take the examples I used. Is the DC-10 close enough to the 747 to insist on comparable accounting of research and development costs?

MR. EDWARDS: I believe that the first one you mentioned was the investment tax credit.

MR. PARKER: Yes.

MR. EDWARDS: I'm not at all sure. Here is a case where, in the airline industry, a different kind of accounting for the investment tax credit might have caused us to suggest that maybe uniformity of the investment tax credit isn't worth all that.

MR. PARKER: You think it is not worth that?

MR. EDWARDS: I think it is very possible that it might not be.

MR. PARKER: I think there are a good many representatives of stockholders who strongly disagree.

MR. EDWARDS: Well, for example, when the investment credit peaks so much in the airlines industry, I'm not at all certain that the investor wouldn't have been better served by letting it come in as below-the-line income item. If you believe in flowthrough anyway, which I do, then I'm not at all certain that wouldn't have been a much better depiction of the facts than an arbitray spreading.

MR. PARKER: Well, if you believe in flow through,

then if it's all right for the airline, why is it not all right for others?

MR. EDWARDS: Because the airline business is not the steel business, and there are differences. I think you have to know the business, and I'm sure you appreciate that, when you compare them, because you do make a distinction in the business. You have got to know what business your are dealing with in the first instance and then you have got to make distinctions between companies within that business even within the same industry.

MR. PARKER: Well, I would gather that on any one of the examples I gave, you would feel that any insistence on something approaching comparable policy wouldn't be justified.

MR. EDWARDS: Well, no. I think we are on the record for supporting elimination of undesirable alternatives.

Give me your next example; I don't want you to generalize on the basis of just the investment tax credit. What was the next one?

MR. PARKER: The DC-10 and the 747, accelerated versus straight-line depreciation, and as much as 100 percent difference in lives of assets that, at least when they come off the manufacturing line, are identical.

MR. EDWARDS: Because of failure to predict obsolescence--is that it?

MR. PARKER: I don't know why IBM uses five years and the leasing company uses ten years on the same machine.

MR. EDWARDS: I think we're really talking about a

period there rather than a concept. You are talking about the concept of depreciation. I think there are certain cases where the accelerated method is more appropriate and other cases where the straight-line is more appropriate.

CHAIRMAN TRUEBLOOD: The extension of this conversation relates to the Arthur Andersen presentation this morning on value, as distinguished from depreciation, for the sake of a systematic amortization which leads to a question from the floor which I must recognize.

The question is asked that you said you would rather evaluate a company at cost than value. If you were buying an oil production company, would you rather have the cost of the oil and gas reserves or the value of those reserves as a consideration in your purchase negotiations?

MR. EDWARDS: I wouldn't hesitate to be the first to say that I would want to know the value before I purchased it but I'm not sure that that is true concerning an investor who is buying shares in major companies. For example, I clearly want the cost basis on those companies for my day-to-day share decisions knowing what I know about how you can go all over the board on value estimates on reserves, rather than an annual estimate of the value of the reserves of the company.

CHAIRMAN TRUEBLOOD: But if in your operation of the company you need to know the value of those reserves, approximate as it may be, then why shouldn't the buyer and seller of your stock have some indication of the estimate of the value of those reserves, however approximate?

MR. EDWARDS: API has just completed a study in which they have gone through--maybe some of you have seen it--the problems of estimating reserves and the problems in estimating values of the reserves and I think that their problems are overwhelming. Frankly, we have reserves we can't put a value on, one that we believe in, even to operate the company internally.

CHAIRMAN TRUEBLOOD: No question about that. The Arthur Andersen people very clearly took the position: We have to decide on the objective, and the implementation is very difficult and we all have that problem in a lot of areas outside your company.

MR. EDWARDS: Well, I don't want to be in the position of rebutting them because they don't have an opportunity to rebut me; but I have trouble with the idea of an objective that we're all going to move to, because it almost sounds like we're right back where we were, in that we still want to go somewhere, but we're not altogether in agreement where that is.

CHAIRMAN TRUEBLOOD: Okay, Oscar. One more question and then we must go on.

MR. GELLEIN: It seems, J. O., these days more and more one sees in the press figures where managements of companies are estimating their earnings six months ahead, four months ahead, or a year ahead. Although I have no research, it just seems to me, as I have been watching the papers, I have seen more of this than ever before.

In the light of your statement, then, on page 8, which in effect says that the prevailing management view is that the

degree of accuracy required for reporting such data to the public has not been achieved, does your Committee view this development with alarm?

MR. EDWARDS: Some of us do. I think that you have to look at the industry; you have to look at the period, the time of year when the publication of the forecast is made. If it's made on the 1st of July, it's more reliable than if it's made on October 1 of the prior year.

We don't have any criticism of those companies who wish to make the forecast and wish to publish it if they have confidence in it, but some of our members have been burned pretty bad on forecasts and have had all kinds of legal problems and class action suits; so the weight of the evidence, we think, comes down that forecasting of one or even two years of profits in the first place has limited meaning and in the second place it's going to tend to be kind of a self-executing thing, if we're not careful.

We've got a project on it. I don't know where we are going to come out. I think you can sense where I come out on it but maybe the rest of the F. E. I. won't.

DEAN DAVIDSON: That's a forecast.

CHAIRMAN TRUEBLOOD: Okay, Howie.

MR. WAGNER: Well, I'd like to close this part of the meeting off by saying that, while I'm a member of the Objectives Study Group and a member of the AICPA, I am also a member of the F. E. I., as you know, J.O., and I personally have been very pleased with what I regard to be a very enlightened attitude by

the membership of the F. E. I., as evidenced by our discussions this morning.

The F. E. I. has been spending a great deal of time in attempting to get at the problems of fair value accounting, the problems or the advantages of forecasting and disaggregation. Their interests and their concerns, really, are not too different from those of the group who are in the practice of public accounting or, for that matter, many of our user groups. Their concerns--and they are also the concerns of many of the public accounting firms represented here this morning--are that we approach these things through evolution, as opposed to revolution, and I personally am very pleased with the presentation this morning and wish to express my appreciation for all the work the F. E. I. is doing. I would close with the expression that I hope that we will continue to be able to work in harness and very closely together to solve the common problems which face accounting in general.

MR. EDWARDS: That certainly is going to be our objective.

CHAIRMAN TRUEBLOOD: Thank you, Howie, and we all share your views. Thank you, J. O.

Robert Morris Associates? Will you introduce yourselves?

MR. CHARLES MCGARRAUGH: Very happy to. I'm Charles McGarraugh, Vice President of Northwestern Bank of Minneapolis, Chairman of the Committee of the Robert Morris Associates involved with relationships with the accountants.

And at my left is Dale Freed, a Vice President of the Manufacturers Hanover, Manager of the Time-Life office here in New York City, and past-Chairman of the same committee.

Robert Morris Associates is a group of bankers engaged in lending money to businesses. It includes a membership of 1300 banks and 5000 individual members. We probably loan as much as 80 percent of all the money loaned to businesses. We consider ourselves vitally interested in this Study Group.

We rely on and have relied on for many years and worked with auditing reports and that is why we're here today. Our emphasis may be a little bit different from some of the other previous members in that we not only deal with those companies who are reporting to the SEC or whose stock is listed on any of a number of the exchanges, but we also deal with all the multitude of other business entities who use audit reports, and although no statistics were available for me, one manager of one of the large accounting firms suggested that as much as 70 percent of the reports issued out of their office on a nationwide basis were reports that were issued for companies other than those companies reporting to the SEC or to stock exchanges.

I would like to say that this Committee should keep this in mind as they regard the emphasis of their various principles; that there are a great multitude of users who are not really represented by stockholders per se--family companies, proprietorships, partnerships, and all the rest of these things--where it is important to have your financial reporting just as accurate as in any other particular case.

Our emphasis today is going to be on three forms.

We would like to discuss your role--and I'm talking about the CPA, as an independent, objective attestor, with a strong plea for more qualitative, subjective judgment; our view as to your primary responsibility; and then, in a very dangerous area, I might add, our impressions of your professionalism.

Going to the first of these three areas rapidly, we think that as an independent, objective attestor, your primary responsibility should be to recognize that you not only do, as one man said this morning, bookkeeping things of adding up dollars and cents, but you must make qualitative judgments, involving, oftentimes, subjective evaluations.

You do a really remarkably good job in the current assets section of your balance sheets. Your whole discussion this morning--I wasn't here yesterday--went around the valuation of the other assets, the fixed assets, the buildings and equipment, the franchises, intangibles, and mineral resources. I'm glad to see your whole discussion has been largely aimed that way; that is, what is the proper way to evaluate these particular important parts of a balance sheet.

I think it is important. It involves not only methods of evaluating shares of stock, but the quality of the evaluation of all these various assets cannot help but have an effect on the quality of the income statement as it goes down through the assets.

We think, as bankers, that we're not really, particularly, overly interested in the commercial loaning end with the earnings per share concept, and we think a lot of sins have

been committed in the desire to keep the earning per share on a relatively even growth pattern over a period of years. We are interested in the profitability of the business. We are interested in the return in relation to net sales. We're certainly interested in the return as a percentage of the beginning net worth.

But the earnings per share concept, although I'm sure it makes a great deal of difference to the stock analyst, is not particularly important to us. As a matter of fact, this is one of the things, we think, that has tended to distort some of the statements we have seen.

Then going on rapidly to the next item, the primary responsibility of the audit report, and who is it for--I was glad to see Mr. Edwards indicate that he thought the reports were for the stockholders and creditors. I agree that, certainly, the stockholders and the creditors are the ones that you are making the reports for. And then he also went on to indicate that the problems of comparability are one of the things that you have to attack.

The comparability factor is important to us. As you probably know, the Robert Morris Associates issues a study of comparative values and related percentages in various industries, and to the extent that this comparability is distorted by the multiplicity of generally accepted accounting principles applied in different ways--for example the computer industry or the air-frame industry--comparability tends to lose its value, and comparability has to be a way of judging what values and what in-

vestments to make.

We would like to go on and suggest that you, as the accountant, should recognize the fact that you are responsible to the user and that there are other things besides just the statements that are of value to the users; we would like to think that the internal control is part of your function and some information that you could pass on to us. We are not particularly interested in the nitty-gritty of the financial housekeeping within a business organization; but if you have found in the course of your audit that the internal control procedures are so sloppy as to require the need for more stringent accounting procedures, this is an important fact in our evaluation of the credibility of the management.

It may be dangerous, but we think forecasting is something that you ought to recognize as a responsibility of the independent accountant. This does not mean that you have to draw up the forecast, because I think this is beyond your competence; but it does mean that you can provide the proper format for forecasts. It does mean that you can and should examine the reasonableness of the assumptions that are made.

You are in a peculiarly important place to do just that which neither the bankers nor the stockholders can do because you can sit down with the management and you can talk to management and say: How did you arrive at this particular assumption and why are you believing this? Was this something that you hoped to do or is it something that you expect to do? Does it represent a sales goal or is it really, truly the way

you look at it?

And if you put it in a forecast, believe me, this will do away with just the kind of an interim kind of report you are getting today where we are going to make so much in the first quarter and the second quarter, and we're going to make \$1.50--and then in the fourth quarter they all of a sudden have a loss of about \$1.50 a share. I don't think this thing would be nearly as prevalent with a more informed and careful forecast and going on that line at the beginning and saying: Look, fellows. This is what we expect to do in the coming year.

How often should it be changed? It should be changed any time during the year that there is a material change and it has to be changed, probably, in the same sort of interim report that they do on a quarterly basis.

This is something that we think you can do.

Another thing that was mentioned just briefly this morning is that the impact of consumerism today--and I didn't hear the man from Nader yesterday--and the impact of the social and ecological responsibilities on business, whether it happens to be banking, accounting, or any kind of business, cannot be ignored. And it certainly represents a very challenging opportunity to the accountants as to: How do you reflect this in the statements?

I liked your example on the steel plant in the south part of Chicago. There's also an impact on a steel plant in Duluth, Minnesota which is being shut down because of pollution.

This impact, the costs of these sorts of things, I don't think have been reflected adequately yet on balance sheets.

One other item that I put in the paper--which, by the way, is a summation of the feeling of a lot of the bankers all over the country--was that maybe in the future you accountants are going to have to do something about managerial competency and look at it in some sort of evaluation. I don't think you are ready to do it yet, and the only reason I think, that it may come in the future is in this respect: As businesses increase in their complexity and as the top management gets further and further away from the investors and the creditors, it's harder and harder to get there and properly review the managerial competency other than as reflected in the operating statement in itself and this is not always adequate.

So this is something you may want to look at. I wouldn't challenge you with that request yet.

I don't know whether I mentioned it before, but I do want to mention it, that we believe in the profession of accountancy. We believe that you have a fine organization. We are quite certain that you have good, comprehensive entrance requirements. As a matter of fact, many years ago I was unable to pass them, so they must be pretty good.

We also believe that your ongoing programs--and I understand you just instituted another ongoing program for a training of people on the staff--are important to the people in maintaining their professional stance.

We're not entirely sure, because of lack of knowledge, how effective your testing and the policing of your membership has been. We do know that we have seen enough instances, as

you have, that are unpleasant--enough suits and enough instances that make us wonder what sort of a policing you are doing, and it's possible that more publicity as to those efforts would tend to improve your profession, tend to make it have a higher standard of adequacy. Believe me, if there's any one group that depends on the accounting profession heavily, it's the banking group. We do need you. We'd like to work with you, and we want and expect to continue to get good results.

CHAIRMAN TRUEBLOOD: Thank you, Charlie. Does Dale wish to speak?

MR. MCGARRAUGH: Do you want to add something, Dale?

MR. DALE Y. FREED: No. Charlie speaks for our whole RMA group. Each of us would differ a little bit on one point or another. This isn't a subject as to which you can get unanimity of opinion on; but Charlie's position paper does represent a consensus.

CHAIRMAN TRUEBLOOD: Well, we find in our Group that it's quite difficult to get unanimity as well.

That was a very gracious presentation, a very good presentation. It's very refreshing to find those who would push us further and further on the matter of internal control, management audits, social responsibility and so on, because so many of our inputs have tended in the other direction, being fearful that some of us may be trying to go too far too fast.

May I start out on the forecasting issue, on which you took quite a strong position? The input record for these hearings has been relatively low on a push in the direction of

cash information, in the sense of forward cash flows, past cash flows, expected cash requirements; whereas I think the members of the Group would agree with me that our interview process generally around the circuit with users has put much more emphasis on that than is evident from some of the input that is being given us today.

I would think you would have an unusual interest in that.

MR. MCGARRAUGH: There's no question but the cash flow is our source of information as to the way a loan is going to get repaid. It's very important.

CHAIRMAN TRUEBLOOD: So when you are talking forecasts, you are not talking only earnings forecasts or projected balance sheets?

MR. MCGARRAUGH: They can be in both forms, as you know, and the forecast of the earnings is an important picture to us, because it's not only the cash aspect of the statement that has validity. Sure, it gives you the opportunity to indicate where the source of cash is going to be in order to pay off a loan, but on the other hand, if this happens to be a term loan, the continued forecast of profitability can materially affect the future flow of cash. Yes, to the extent that we are interested in cash flow, on the short run it's very important but the profitability forecast is too, to give us a measure of comfort.

CHAIRMAN TRUEBLOOD: Let me introduce Andy Reinhart to you. Some of you saw him yesterday. He's Vice President of

the North American Operations of Singer. He has been troubled with the stockholders meetings or some such proceedings.

Any other questions from the Group? Sid, are you ready? Andy?

MR. REINHART: I'd like to talk a little about the forecasting part.

For example, if you took a relatively large, diversified company operating in a number of different industries and in many countries throughout the world, what kind of support would you anticipate in the annual report for a forecast which might be made up of, perhaps, hundreds of assumptions in different areas?

MR. MCGARRAUGH: You pose the most difficult question, I agree, because you have to have an inordinate number of assumptions. If you are going to cover all the foreign operations, all the different product lines, and all the different situations; and I really can't answer that question, because I don't know. I don't know what you do in that kind of a situation.

MR. RHEINHART: I would also like to ask you about the competency of people to make forecasts. We have a lot of trouble making forecasts ourselves sometimes, supposedly knowing about our own business. I would seriously question your feeling that independent public accountants would be good at making forecasts for us. What would happen where we had a difference of opinion with accountants with regard to a forecast?

When we talk about certifying to something which has already happened, we don't really have a lot of disagreement

over that. We may have some disagreement over accounting practices or various methods of doing something but at least it's a fact that we can discuss and usually come to agreement about. But suppose, for example, that I were to say: I think our sales are going to be ten percent higher this year than last year and our accountant said: No, I think it's only going to be five percent. What do you do in this instance? How would you express both opinions?

MR. MCGARRAUGH: Well, let me answer one of the first things you said. I did not mean to imply that the accountant would prepare the forecast. I do not think that's within his competence. I do think that many businesses do an excellent job in forecasting and where you do have results that are materially different from that forecasted, you can identify some outside pressures that couldn't reasonably be foreseen; this is all right, as long as you have identified as you go along.

As far as a disagreement between you and an accountant on a forecast, I do not think that the form of attestation on a forecast from a firm of accountants would be the same form of attestation as would be on the part of a certificate of past performance because I think it's different. But I do think that an accountant has a particular place that he can look at this thing and say: These are reasonable.

If they are so unreasonable that he wants to make an exception in a footnote, that's fine. But otherwise, he lists them down there, and he says: These are the forecasts and in our opinion they are reasonable.

Between 5 and 10 you're not going to get any argument but if you put in 100 percent because it's what you would like to have happen and you have only had 10 percent over a period of years and you have no new products, he ought to put a footnote in there.

MR. REINHART: What kind of detail would you anticipate that the accountant would go through in order to verify the forecast? I mean, I'm kind of worried myself about our bill, I suppose.

MR. FREED: Let me talk to the general subject a little bit if I could just postpone your latest specific question.

We work with forecasts a lot in our bank, as most large banks do. We, as a matter of practice, require forecasts on every term loan for the length of the term loan and this, of course, involves us with a lot of diversified, multi-national companies. We start with a forecast in whatever form it is presented, and if I can just digress a moment, the RMA's position on the role of accountants here, first, is the methodology.

It's surprising to me, but there a number of major companies that submit forecasts that don't hang together. They don't provide for enough fixed assets to produce the volume that they expect to sell in 1974. They don't provide enough dollars to provide the inventory necessary to support that volume a couple of years out. They omit one little item or another. I still find it difficult to believe, but it's true.

This is an area where accountants should certainly provide expertise very easily, just on the mechanical side.

As to the degree of involvement in the assumptions--

I don't know. Maybe Charlie and I differ a little on this. What I'd like to see is the assumptions set forth first because all we're really talking about is: If these things come to pass then the results will be what you see on the following page with the emphasis, therefore, on the assumptions, and I think the user, certainly in the banking business--the user has to apply his own judgment in appraising the validity of those assumptions.

As to the degree of detail that the forecast should include, when we are dealing with diversified companies, we almost always identify those areas that generate the most cash and ask for details on that segment of the business. We de-emphasize the international operations even though we recognize that by and large they are generating more and more profit. The availability of cash from those operations is subject to a little more doubt. We would hesitate to structure a term loan dependent on the availability of cash from foreign earnings.

So obviously, it's a judgment matter but we will almost always go behind the company forecast into a couple of the principal operating divisions.

You asked how detailed the audit would be of the forecast. Well, certainly it should be detailed enough to review all the mechanics and to make sure that there are no structural problems in the methodology. As to how far an accountant should go in reviewing the assumptions, I agree with a comment that Mr. Wagner made a little while ago; we're dealing here in evolution, and not revolution. I don't think that forecasting is

new to accountants. I think that they cannot judge the value of inventory without satisfying themselves that Singer sewing machines are going to sell next year.

If you go into a new Friden computer, maybe if you have 10,000 of those in a warehouse some place they should do a little forecasting as to the salability of that product before attesting to the value of the inventory. I think they are already doing this.

So maybe what we are suggesting is that they go just a little bit farther and admit to the user of the financial statements that they are in fact doing a lot of future-oriented work in doing their present auditing.

MR. REINHART: In your own forecasting, what would you consider to be a margin of error? I mean, would you be happy if you were within ten percent, or 25 percent? What would you consider to be a reasonable projection of a company. Let's say that we were projecting we were going to make \$1 a share this year? That's not our projection, by the way.

Would you change that if you thought it was going to go below 90¢ or above \$1.10?

MR. FREED: I couldn't answer that. I think it has to depend entirely on the industry and the sensitivity to economic trends.

What we do in our own bank is estimate high, low and medium forecasts, again emphasizing cash.

In a company such as yours, you have earnings that you hope you will attain next year, but if something unforeseen comes along and those earnings are not generated, you have, you

know, half a dozen or a dozen alternate plans of raising money; and as Charlie was saying, we're very interested in the earnings, but as a component of the cash flow. We look very carefully at the flexibility, the alternatives that are available to the chief financial officer, in making loans because we don't expect his earnings forecast to be accurate. It's just a stroke of luck if it is just exactly accurate. But what can he do if it falls short? He can generate cash in a number of other ways.

MR. REINHART: Did you say that it's a stroke of luck if the forecast is accurate? But you would like it to be published?

DEAN DAVIDSON: Dale Freed has really commented a bit upon the questions I wanted to ask, but let me ask, maybe to clarify in my own mind the point, two specific questions which are really related to Andy's first two questions.

Of what use do you think an income statement of a firm turning out a multiplicity of products in a large number of countries spread throughout the world, and showing only a single income figure,--of what use is that single figure? Or would you rather have it broken down by types of products or countries in which that income was generated?

MR. FREED: There's no doubt in my mind that it's more meaningful to have the kind of detail that you suggested in the alternative.

DEAN DAVIDSON: Might the forecast follow the same procedure that you use in reporting income, then, in terms of such division?

MR. FREED: Yes. As I suggested before, I would put much more emphasis on domestic earnings generating ability, as opposed to foreign.

DEAN DAVIDSON: Well, the second question, which again, relates to this--you touched upon it briefly when you spoke of inventories, but, of course, much of the discussion this morning has related to capital assets, to plant assets, and in your statement you say that you think the accountant, in looking at the assumptions and forecasts, should pass upon the reasonableness of those assumptions as well as upon the mechanical details--does the accountant face that problem now in passing upon the reasonableness of the assumptions with regard to continued use of plant facilities?

That is, can you see any difference between the kind of discussions that might go on between the accountant and the financial management of the firm with regard to continued use of depreciable facilities? Would that discussion in your opinion, differ from the kind of discussion that would go on about the reasonableness of assumptions on the forecast?

MR. FREED: I think they are very close, as I mentioned before, I think it's just a question of evolution, rather than a different subject that we are talking about, and I certainly recognize the difficulty in either event.

RCA was in the computer business right up until the minute they decided they weren't going to be in it, so you had a plant that was worth X dollars as a component in a continuing business one day, and the next day--I don't know. Was it worth

anything? Certainly the value was radically less.

The same kind of rationale, the same kind of analysis, has to go into effect whether you are valuing that plant on a balance sheet or in relation to a forecast.

CHAIRMAN TRUEBLOOD: I have a question from the floor that fits directly into this, Dale; and then Oscar wants to talk.

The question from the floor came before you mentioned RCA, but it has to do with precisely that kind of thing, in the sense both of the introduction of new products, like a 370 replacing a 360 on the IBM line, being superimposed, or the elimination of a product line in the matter of RCA.

The question is: Given knowledge of management--presumably, knowledge by their public accountants--where does the responsibility fall, and what is the timing for such announcements? I suspect the bankers are apt to be in on that kind of thing, too.

MR. FREED: I wish we were more often than we are.

MR. McGARRAUGH: You pose a very, very difficult problem, and I don't know how to answer that, because sometimes we wonder how long management has known what they are going to do prior to the announcement date. Sometimes it comes to us as a sudden, unpleasant surprise. Sometimes we have some warning on it.

I would say that as a matter of practice the announcement should be made to all parties at the same time. There's certainly a responsibility to the public as well as to the banker

and I have to admit at times we may know ahead of time; we like that, but that may not be right.

CHAIRMAN TRUEBLOOD: But assuming you are a creditor, conceptually would you think you should know ahead of the public?

MR. MCGARRAUGH: No, I don't think so. I think this is one thing we have to start facing, bankers and accountants and everybody else, that the individual has some rights, and these rights have been neglected in the past as evidenced by the prevalence of the suits that are coming, and as I mentioned before, the consumerism that's a little bit rampant. The individual is a lot smarter than you think he is, and he's a lot more aware of what's going on; he's going to demand his rights and you better face it. And that includes us as well as you.

CHAIRMAN TRUEBLOOD: First Oscar, then Frank, and then I have one from the floor.

MR. GELLEIN: On page 3 you observe that perhaps overemphasis on earnings per share as an indication of performance has had an adverse effect on the balance sheet. We have heard from others here from time to time, too, that perhaps, as someone said many years ago, a resurgence of the balance sheet is needed. Would you comment on the general way in which you think it might be desirable to reorient the balance sheet?

MR. MCGARRAUGH: I think all your discussions have been trying to arrive at, and I don't know if you can define it--economic value, fair value, current value--some value that represents--it's a cliché--"the facts."

If you have got the facts on the balance sheet this

has got to improve your income accounts because, after all, they are a factor of the income statement.

Two comments seem to be relevant here, and one of them is: Was it in 1968, that a large number of companies went from accelerated to straightline depreciation? And in every case, of course, their earnings improved and in some cases very markedly. I submit there wasn't any change in the economic vitality of the business but their earnings per share, in some cases, doubled.

Now that ploy seems to have worn off so in the statements we see going through now, occasionally, there are a lot of people going from LIFO to FIFO and all of a sudden we have got better earnings.

I don't think that company is a bit different than it was before; these are the things we're talking about.

MR. WESTON: This question relates to forecasts. The prepared paper by the F. E. I. stated their view that business does not yet have the ability to make forecasts which have the degree of accuracy required for reporting to the public; we touched on that briefly although we didn't get a chance to ask them why they believed that.

You advised us that most major lenders insist on forecasts. But there seems to be a conflict here as to the validity or the usefulness of forecasts in terms of lending and the public. Could you give us some observations as to how accurate or how useful the forecasts are that you do receive and whether they might also be useful to investors?

MR. MCGARRAUGH: I'd like Dale to second me on this, but the forecasts that we get are very useful to us. We are finding that in the banking business now more and more we are running into term loans, and term loans have to involve a view into the future, both as to cash flows and profitability.

We recognize the limitations. We recognize that other forces can change them. And I understand, I think, the financial executive's reluctance to go to forecasting because what you are dealing with is the unsophisticated man who is going to sue you because you said you were going to do something and you just didn't do it. I think you have to recognize that you are going to run into that sort of problem and deal with it. But as long as the forecast has been done in good faith, on good assumptions, I think that you will prevail in court. Eventually it will resolve that a forecast is a legitimate part of the enterprise accounting. But it will take a little while and a little knowledge. You can neither protect the public from its ignorance nor can you ignore that it is, maybe, in many cases, smarter than you think.

CHAIRMAN TRUEBLOOD: One final question, which comes from the floor, and I'm sure you have given it a good bit of thought.

It's clear that some banks continue to make at least certain kinds of loans based on unaudited statements as distinguished from audited statements. The question is, in terms of the activity of this Group establishing objectives from which standards would ultimately flow: Should we make any

distinction in our thinking between those two kinds of businesses and two kinds of end products.

MR. McGARRAUGH: I'm sorry. I don't understand the nature of your question, Bob. I'm sorry.

CHAIRMAN TRUEBLOOD: Well, the question, as I read it, as it was written from the floor, is: let's make the distinction between the small company, which may come to some banks with unaudited statements, as distinguished from the larger, traded company which deals only with audited statements.

The question is: Should there be any difference in standards or content of those statements because of the nature of the business or because of the lack of attestation?

MR. McGARRAUGH: I guess I have to answer it this way: The emphasis that we may put on a statement that comes to us and the reliance that we may put on a statement that comes to us, whether it's audited or unaudited, makes a difference. We may even do this: Go out and do our own auditing with our own people to get more knowledge. But other than that, I don't want to respond to it, except that there's a difference in the reliance that we might put on those kinds of statements.

CHAIRMAN TRUEBLOOD: It's only in reliance. That is, you interpret it and regard it in exactly the same way for your loaning purposes except with respect to reliance?

MR. McGARRAUGH: Yes, but, you see, that's the whole guts of it.

CHAIRMAN TRUEBLOOD: A good answer.

Thank you very much. We'll break for lunch. We will

return promptly at two o'clock.

(Whereupon at twelve twenty-five o'clock the meeting was adjourned for luncheon.)